Sharekhan by BNP PARIBAS

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Divis Laboratories Limited

Strong quarter; Robust growth outlook

Pharmaceuticals	Sharekhan code: DIVISLAB	Result 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. 4,117**	
Price Target: **Rs. 4,810**	↑

↑ 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)	8.2 lakh
BSE code:	532488
NSE code:	DIVISLAB
Free float: (No of shares)	12.8 cr

Shareholding (%)

Promoters	52.0
FII	20.5
DII	16.7
Others	10.81

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	6.0	18.9	13.7	80.3
Relative to Sensex	2.6	14.1	-2.8	20.6

Sharekhan Research, Bloomberg

Summary

- We maintain our Buy recommendation on Divis Laboratories Limited (Divis) with a revised PT of Rs. 4,810.
- Divis reported yet another impressive performance for Q4FY2021 with results ahead of estimates. Sales for Q4 were up 28.7% yoy while PAT grew 50.4%
- Expanded capacities commissioning coupled with a robust growth outlook could open up substantial growth opportunities for the company.
- Divis has identified new growth avenues which include shortlisting of next set of 10 molecules and pursuing opportunities in contrast media manufacturing, which could be the key growth drivers.

Divis Laboratories Limited (Divis) reported yet another impressive performance for the quarter with results ahead of estimates. Consolidated sales for the quarter stood at Rs. 1,788 crore, up 28.7% y-o-y, driven by strong growth across both segments. Operating profit for the quarter stood at Rs. 716.3 crore, up strongly by 61.2% y-o-y. Operating profit margin (OPM) expanded by 800 bps y-o-y to 40.1% because of gross margin expansion and savings in other expenses. Tracking the strong operating performance, adjusted PAT stood at Rs. 498 crore, up 50.4% y-o-y and was ahead of estimates. There are immense opportunities for companies such as Divis, as global pharma majors world over are increasingly looking for a reliable and dependable source of procurement for APIs. Further, Divis has completed a significant part of its capex plans and both new plants – DC Sez and DCV Sez are undergoing qualification rounds. Going ahead, commissioning of the new plants coupled with a sturdy growth outlook are likely to open up substantial growth opportunities. Moreover, recently Divis has received clearance for the Kakinada plant and expects work to commence soon once the ongoing second wave of Covid eases off. The new areas of contrast media manufacturing and the next set of 10 molecules identified by the company would also be key drivers for growth going ahead as the management expects the set of new molecules to offer an addressable market opportunity of $ 20 bn. Of the Rs. 400 crore capex announced for the custom synthesis business, Divis has commenced production at one stream and is on track to achieve completion for the other part. The company's strict adherence to quality 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. Therefore, sales and profit are expected to post at a sturdy 27%/32% CAGR respectively over FY2021-FY2023E.

Key positives

- Revenue grew impressively by 28.7% y-o-y, aided by strong growth across the API and custom synthesis business.
- OPM has expanded by sturdy 800 bps y-o-y to 40.1%, backed by gross margin expansion.
- Management is confident of sustaining the current strong margin trajectory.

Key negatives

- Delay in starting construction of Kakinada plant.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 4,810: Divis has identified new growth avenues in addition to existing ones, which could drive the company's growth going ahead. These include shortlisting the next set of 10 molecules and pursuing opportunities in contrast media manufacturing. Moreover, strong growth in existing molecules would well complement the growth plans from the new molecules. Emerging opportunities in the custom synthesis business also would benefit Divis, given its established capabilities, backward integration, focus on quality, and benefits of scale. With major capacity expansion plans concluding, the company is best placed to cater to increasing demand from global pharma companies. Going ahead, we expect Divis to reap benefits of backward integration, capacity expansion, and emerging opportunities in the API and custom synthesis space. Given the better-than-estimated results for Q4FY2021, we have revised upwards our earnings estimates for FY2022E/FY2023E by 3% and 6%, respectively. At the CMP, the stock trades at rich valuations of 41.2x/31.7x its FY2022E/FY2023E EPS, respectively; and given the strong growth prospects, we expect rich valuations to sustain. We maintain our Buy recommendation on the stock with a revised PT of Rs. 4,810.

Key risk

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

Valuation (Consolidated) Rs cr

Particulars	FY2019	FY2020	FY2021	FY2022E	FY2023E
Net sales	4946.3	5394.4	6969.4	8966.7	11276.3
Operating Profit	1871.8	1822.2	2859.9	3721.2	4736.1
OPM (%)	37.8	33.8	41.0	41.5	42.0
PAT	1321.7	1294.5	1984.3	2650.1	3447.8
EPS (Rs.)	49.8	48.8	74.8	99.8	129.9
PER (x)	82.7	84.4	55.1	41.2	31.7
EV/EBIDTA (x)	54.8	56.6	36.7	27.8	21.4
ROCE (%)	24.9	22.6	27.7	29.7	30.3
RONW (%)	19.0	17.7	21.3	22.9	23.5

Source: Company; Sharekhan estimates

Sturdy performance for Q4FY2021: Divis reported yet another stellar performance for Q4FY2021 with earnings ahead of estimates. Consolidated sales for the quarter reported growth of 28.7% y-o-y to Rs. 1,788 crore, backed by strong growth across both segments. The generic business for the quarter constituted around 60% of revenue, while 40% was through the custom synthesis business. The neutraceuticals business sales stood at Rs. 166 crore for the quarter. Operating profit grew sharply by 61% y-o-y to Rs. 716 crore and was ahead of estimates. OPM grew by 807 bps y-o-y to 40.1%, attributable to a 450 expansion in the gross margin coupled with ~300 bps savings in other expenses. Gross margin expansion is on account of a favourable mix and benefits of backward integration accruing. During the quarter, the company paid a one-time incentive equivalent to a month's salary to its employees as a token of appreciation for work during the pandemic. Depreciation charge increased by 40% y-o-y, as the company has capitalised its assets of Rs. 173 crore during the quarter. The company reported forex gain amounting to Rs. 4 crore during the quarter as compared to Rs. 57 crore gain in Q4FY2020. Consequently, adjusted PAT stood Rs. 798 crore, up 50.4% y-o-y and ahead of ours as well as street estimates.

Potential from new opportunities in APIs and capacity expansion to aid growth: Divis is a leading player in the API space globally and is expected to benefit significantly from opportunities in the space. The company has identified new areas, which would fuel growth going ahead; and this includes the next set of 10 molecules, which have gone off patent and offer a sizeable growth opportunity. Management sees an opportunity of around $20 billion from these molecules and expects products to roll out over the next two years i.e., between FY2023-FY2025. In addition to these, the existing products basket is well placed to grow as Divis caters to around 60%-90% of the world's demand for a few of the existing products and these could be key growth drivers. Divis' foray in the contrast media space is also likely to open up substantial growth opportunities and management is focused on developing and growing the business. The contrast media industry has been growing at a rate of 10%-15% annually and the market size for Divis' products is pegged at around $4 billion-6 billion globally, which is significant. Players such as Divis, with an established track record, long-standing customer relationships, strong in-house capabilities, and capacities, are amongst the preferred partners for global pharma companies and, hence, enjoy a pricing power, which bodes well for the company. Divis has successfully completed its capex plan amounting to Rs. 1,800 crore, which includes two plants – DC SEZ and DCV SEZ – and de-bottlenecking exercises. Currently, both the plants are under validations and the commercial production is expected to commence in the near future. Further, as both these plants would be manufacturing existing products, which are approved by regulators, there is no requirement of a major approval or an inspection by regulators. Strong capabilities such as technical/process intensive manufacturing practices differentiates Divis from other players and acts as an entry barrier. Given the immense growth opportunities emerging for API players, coupled with expanded capacities coming on stream, best-in-class manufacturing practices would be one of the key growth drivers for Divis.

Custom synthesis segment's capex progressing as per schedule: Divis is experiencing strong demand traction, from global pharma companies. Anticipating a strong demand outlook, the company had announced a capex of Rs. 400 crore during FY2021, with an expectation to conclude the capex over the 6-9 month time frame. As of FY2021, Divis has completed a part of the project and has already commissioned the same. The balance portion of the project is also progressing as per schedule and the company expects to commence production in the early part of FY2022. As the expanded capacities are pre-booked, Divis would be in a position to commence commercial production once the expansion plan is completed.

Q4FY2021 Concall Highlights

- **Capacity expansion plans:** As of FY2021, Divis has capitalised assets amounting to Rs. 1,183.5 crore. These include setting up of two plants at DC SEZ and DCV SEZ. In addition to this, the company has completed de-bottlenecking exercise at existing plants. Currently, both the new plants are undergoing validations and are expected to commence commercial production soon. As Divis would be manufacturing approved products at these plants, there would be no major regulatory approval required and the company could commence commercial production once the validation rounds are done. Over the past two years the company had announced a capex of Rs 2500 cr and off this the company has already completed capex of Rs 1800 cr, while the balance Rs 700 cr would be pursued in the current year.

- **Kakinada Plant Updates:** Divis has received clearance from the government/Court for Kakinada plant, and management has indicated that construction work would be commencing with the cooling off of the second COVID-19 wave. The Kakinada plant would entail an investment of Rs. 600 crore.
- **API: CSM revenue mix:** Q4FY2021 revenue from generic APIs stood at 60% of sales, while those from custom synthesis stood at 40%. Going ahead, management sees the mix between both the segments to be around 50:50.
- **Geographical mix:** The share of revenue from the developed markets of the US and Europe stands at 71% for the quarter, while the share of exports stands at 90%. For the full year FY2021, exports constituted around 88% of sales.
- **Molnupiravir:** Divis is the authorized API manufacturer for MSD's (Merck, Sharpe and Dohme) drug, Molnupiravir; and Divis is authorized to supply the API to MSD's partners in India. Consequently, Divis has set in place three different streams for making Molnupiravir API, including one in the new DCV SEZ. Of the three streams, one would be catering to India, while the other two would be for exports.

Results Rs cr

Particulars	Q4FY21	Q4FY20	YoY(%)	Q3FY21	QoQ(%)
Net revenues	1788.2	1389.7	28.7	1701.4	5.1
Operating profit	716.3	444.5	61.2	691.2	3.6
Other Income	19.5	19.7	(1.1)	16.8	16.3
Interest	0.2	0.4	(52.3)	0.3	(22.2)
Depreciation	70.1	49.8	40.8	68.2	2.8
PBT	665.5	414.0	60.8	639.6	4.1
Adj. PAT	498.0	331.2	50.4	468.1	6.4
Margins			**BPS**		**BPS**
OPM	**40.1**	**32.0**	**807**	**40.6**	**-57**

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.

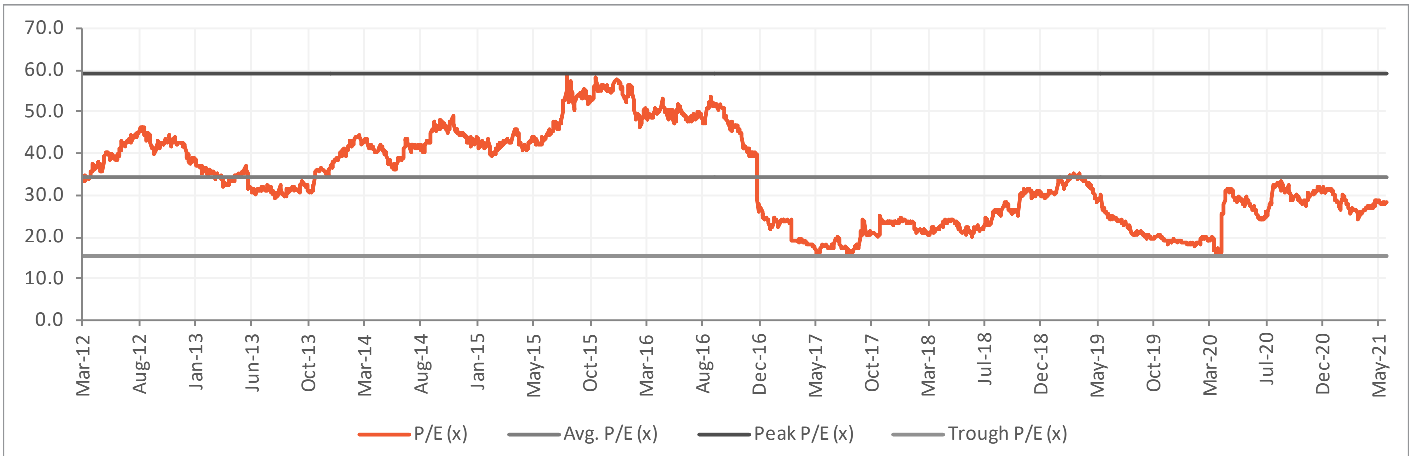
Company Outlook – Robust earnings growth

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 also promising. The hunt by global companies for alternative procurement source for API/intermediates 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 has almost completed 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 had announced plans to enter the contract media manufacturing space, which is growing annually by 10%-15%. With a substantial global addressable market size of $4 billion-6 billion, this space has the potential to provide considerable growth opportunities.

Valuation – Maintain Buy with a revised PT of Rs. 4,810

Divis has identified new growth avenues in addition to existing ones, which could drive the company's growth going ahead. These include shortlisting the next set of 10 molecules and pursuing opportunities in contrast media manufacturing. Moreover, strong growth in existing molecules would well complement the growth plans from the new molecules. Emerging opportunities in the custom synthesis business also would benefit Divis, given its established capabilities, backward integration, focus on quality, and benefits of scale. With major capacity expansion plans concluding, the company is best placed to cater to increasing demand from global pharma companies. Going ahead, we expect Divis to reap benefits of backward integration, capacity expansion, and emerging opportunities in the API and custom synthesis space. Given the better-than-estimated results for Q4FY2021, we have revised upwards our earnings estimates for FY2022E/FY2023E by 3% and 6%, respectively. At the CMP, the stock trades at rich valuations of 41.2x/31.7x its FY2022E/FY2023E EPS, respectively; and given the strong growth prospects, we expect rich valuations to sustain. We maintain our Buy recommendation on the stock with a revised PT of Rs. 4,810.

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/EBITDA (x)			RoE (%)		
				FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
Solara Active Pharma Sciences	1767	3.5	4457	28.3	23.9	18.3	17.1	13.6	10.8	13.9	14.4	16.2
Divis Laboratories	4,117.0	26.5	1,09,280	55.1	41.2	31.7	36.7	27.8	21.4	21.3	22.9	23.5

Source: Company, Sharekhan Research

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

1) Adverse regulatory change

2) Regulatory compliance risk

3) Forex volatility

Additional Data

Key management personnel

Dr. Murali K. Divi	Managing Director
Mr Kishore Babu	CFO
Dr. Kiran S. Divi	Whole time Director and CEO
Ms. Nilima Prasad Divi	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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