Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Divis Laboratories Ltd

Price correction provides a good opportunity

Pharmaceuticals	Sharekhan code: DIVISLAB
Reco/View: Buy ↔	CMP: Rs. 4233
	Price Target: Rs. 5,620 ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 18.45
Updated Oct 08, 2021

Low Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

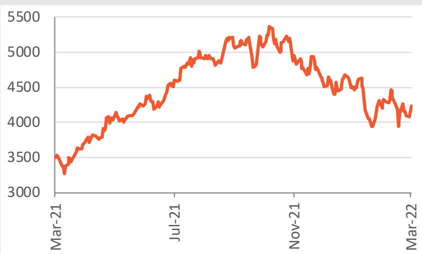
Company details

Market cap:	Rs. 1,12,367 cr
52-week high/low:	Rs. 5,425 / 3,154
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	-2.3	-7.5	-16.3	20.9
Relative to Sensex	4.3	-0.5	-10.0	13.8

Sharekhan Research, Bloomberg

Summary

- Divis' has charted out a strong growth path encompassing its 6 growth pillars, which would propel the growth going ahead.
- The CSM business is expected to stage a double-digit CAGR over FY2022E to FY2024E, driven by a expanded capacities going on stream and strong demand environment.
- Long standing customer relations, established capabilities, backward-integration, focus on quality, and benefits of scale would be the key positives., while depreciating INR/USD also bodes well for Divis
- The Stock price has corrected by ~27% in over the past five months and provides a good opportunity for investors. We re-iterate Buy recommendation on the stock with unchanged PT of Rs 5,620.

Divis Laboratories (Divis) has charted out a growth path which includes focus on growth in existing molecules and market shares gains, pipeline of new molecules across therapy areas which are expected to go off patent over the next 2 years. Recently, the company has concluded a capacity expansion plan across API's as well CSM (Custom Synthesis) segments, thus offering ample visibility for growth. Efforts to geographically diversify the procurement base and higher share of long-term customer contracts with a price escalations clause would enable it mitigate cost pressures. In addition, a depreciating INR / USD (down ~3% since Jan 2022) also bodes well for Divis. Further the stock price has corrected by ~27% over the past five months and provides a good entry point for investors.

On well charted growth trajectory: Over the years, Divis has developed strong growth capabilities, stringent quality control norms and customer relations which has fuelled the growth. Going ahead Divis has identified six pillars which would propel the growth. These include growing existing molecules and market share gains from them, new areas of contrast media, expanding the offerings in the sartans (APIs), growing the custom synthesis business, and focus on products going off patent over the next two years. Overall Divi's revenues are expected to stage a 19% CAGR over the next 2 years

CSM business to sustain the strong growth momentum: Divi's custom synthesis business is a margin accretive one, but at times it is lumpy in nature. Divi's is experiencing strong demand traction from across its clients and expects the traction to improve further, which would be supported by expanded capacities. 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 CSM sales to report a double-digit CAGR over FY2022E to FY2024E.

Well placed to combat cost pressures: In a recent concall, Divi's management mentioned of increasing cost pressures attributable to high import costs due to energy crisis in China. While the input costs pressures are expected to stay in the near term, Divi's is a well-placed to combat these pressures aided by managements strategy to geographically diversify the procurement base. Also, a higher share longer term contracts with a price escalations would enable the company to mitigate the cost pressures and bodes well.

Our Call

Valuation – Re-iterate Buy with unchanged PT of Rs. 5,620: Divis' growth prospects across businesses stay bright and will propel growth going ahead. Further, the tie-up for Molnupiravir also offers sizeable growth opportunity for Divis. Given its established delivery capabilities, strong customer relations, backward-integration, focus on quality and benefits of scale coupled with commissioning of expanded capacities are the key growth drivers, which is complimented by a depreciating INR/USD. At CMP, the stock trades at attractive valuations of 43.4x/35.4x/29.9x its FY22E/FY23E/FY24E EPS, respectively and offers room for further expansion. Further the stock price has corrected by around 27% in over the past 5 months pointing at a good opportunity for investors to enter the stock and hence we re-iterate Buy recommendation on the stock with unchanged PT of Rs. 5,620.

Key Risks

1) Adverse regulatory changes; 2) Unfavorable forex movements.

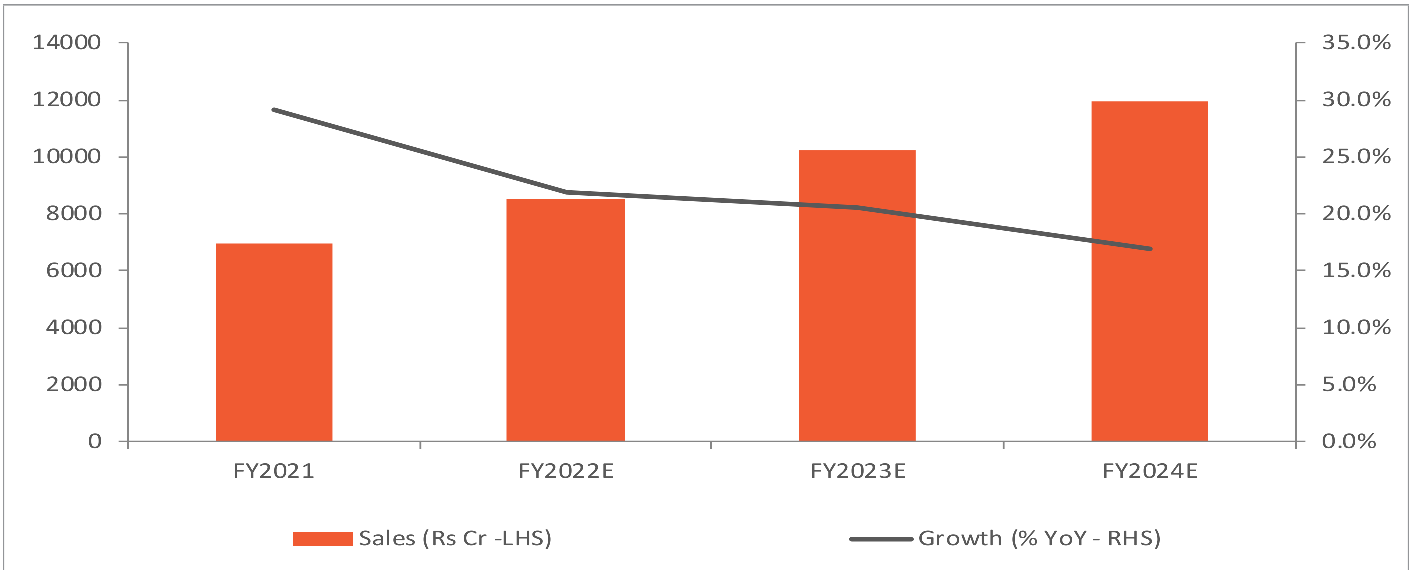
Valuation (Consolidated) Rs cr

Particulars	FY2020	FY2021	FY2022E	FY2023E	FY2024E
Net sales	5394.4	6969.4	8495.9	10234.4	11961.1
Operating Profits	1822.2	2859.9	3602.3	4380.3	5143.3
OPM (%)	33.8	41.0	42.4	42.8	43.0
PAT	1294.5	1984.3	2586.2	3170.5	3756.5
EPS (Rs)	48.8	74.8	97.4	119.4	141.5
PER (x)	86.8	56.6	43.4	35.4	29.9
EV/Ebidta (x)	58.2	37.7	29.5	23.9	19.8
ROCE (%)	22.6	27.7	29.1	29.3	28.4
RONW (%)	17.7	21.3	23.0	23.0	22.2

Source: Company; Sharekhan estimates

On well charted growth trajectory: Over the years, Divis has developed strong growth capabilities as well as customer relations which has enabled the company to stage an impressive 21% revenue CAGR over FY2018-FY2021. Better scale of operations, comparatively shorter delivery times and stringent quality control norms have enabled divis to cater to its customer's requirements, thus driving the growth. Going ahead, the management now has charted out a strong growth path ahead. It has identified six growth pillars which would propel the growth going ahead. Divis' basket of established generics products in which the company has a market share more than 60-70 % is expected to sustain the double-digit growth trajectory. Secondly, the company is increasing the capacity for molecules in which it has around 30% market share (with a strong growth potential) and through the capacity expansion, it plans to achieve a market share of 60-70% like established generics. Thirdly, basis the technical advantage towards areas of impurities in the Sartans Divis plans to enter areas of Sartans (for API). Moreover, Divis is looking at contrast media manufacturing as a key growth driver and is eyeing for substantial contracts from big pharma players for the same. Moreover, Divis is getting orders for API as well as synthesis for the contrast media business. Lastly, the company has shortlisted the drugs that are expected to go off patent over the next two years and is looking to launch products post the patent expiry. Collectively, Divis plans to focus on these areas, which are expected to lead to a 19% revenues CAGR over FY22E-FY24E.

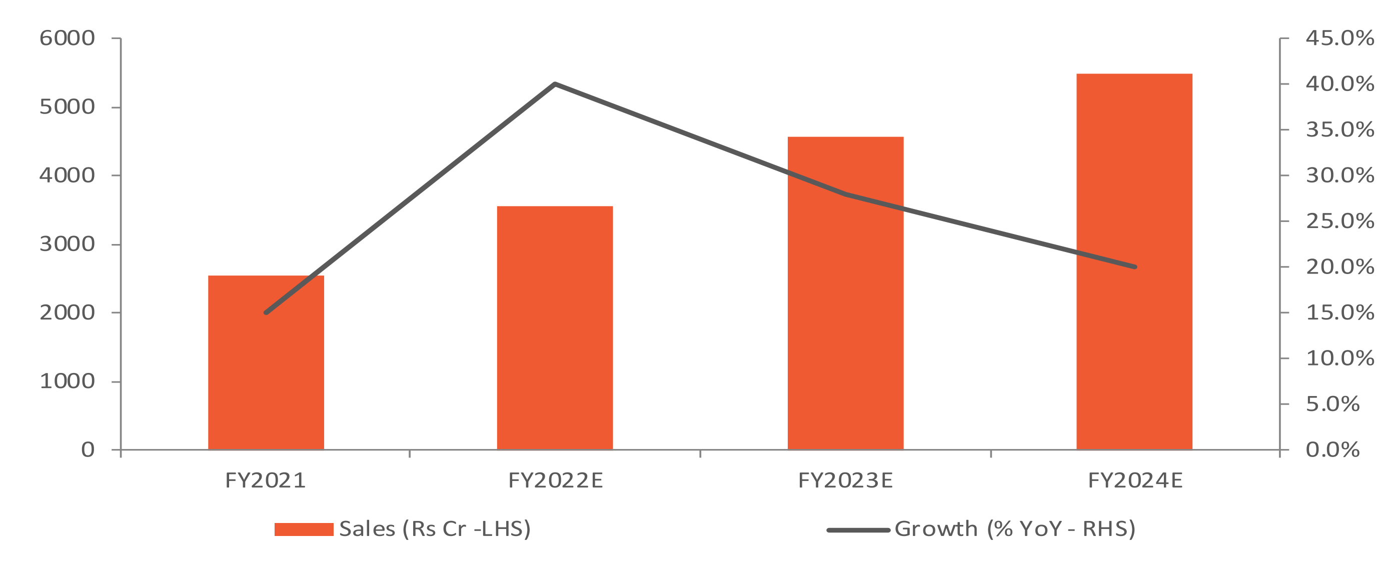
Overall Sales – Growth trends



Source: Company, Sharekhan Research

CSM business to sustain the strong growth momentum: Over the year, Divis 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 demand products. The custom synthesis business is a margin accretive one, but at times it is lumpy in nature. Divis is experiencing strong demand traction from across its clients. Further, recently it has concluded a capacity expansion plan for one of its clients, entailing an investment of Rs 400 cr. Therefore, as of quarter ending December 2021, the new facilities have commenced operations and revenues from the same are reflected in the top line, which are likely to ramp up further and drive the CSM segment growth. 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 CSM sales to report a double-digit CAGR over FY2022E to FY2024E.

Custom Synthesis Segment Sales – Growth trends



Source: Company, Sharekhan Research

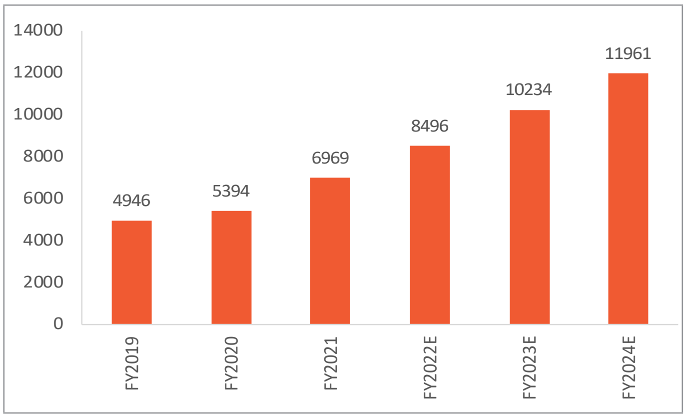
Divis better placed to capitalize on new virus variants, if any: Divis is the authorized API manufacturer for Molnupiravir. Consequently, Divis has set in place three different streams for making Molnupiravir API, including one in new DCV SEZ. Of three streams, one would be catering to India, while the other two would be for exports. Further, as per industry reports the innovator of Molnupiravir, aims to manufacture 20 mn doses of Molnupiravir in in CY22 as against 10 million doses in Cy21. However, the demand for Covid drugs has been highly volatile given the moderation in covid cases. While there exists a sizeable addressable opportunity for Divis, but volatility in demand for the customers drugs lead to a possible deviation. Also, Divis has built-up its capacities in a way that it can cater to the customers demand in a short span of time. Secondly Divis sees the drug development for covid to continue as it sees a possibility of newer variants emerging. Hence, in the event of emergence of any new virus variant or demand for other products increasing, Divis is well placed to capitalized on the opportunity given flexible manufacturing facilities.

Levers intact to combat cost pressures: Divis' operating margins for 9MFY22 stood at ~43.1% which translates into an expansion of 170 bps y-o-y. However recently, the management mentioned of increasing cost pressures attributable to high import costs due to energy crisis in China. While the input costs pressures are expected to stay in the near term, Divis is well-placed to combat these pressures aided by the managements strategy to geographically diversify the procurement base. Also, a higher share of long-term contracts entered in to with its customers has a price escalation clause which can enable it to pass on the higher costs. Strong backward integration measures, better operational efficiencies and benefits of leverage would enable the company to partly offset the cost pressures and thus bodes well.

Capacity expansion plans to support growth: As of 9M FY22 the company has capitalized assets worth 765 cr and in Q3FY2022, has capitalized assets amounting to Rs. 196 crores. Going ahead, in to Q4 it plans to spend another Rs. 100 crore. In the next 2-3 years, Divis plans to spend around Rs 1000 -2000 crore which would be largely towards setting up greenfield capacities at Kakinada and Krishnapatnam port. However, the capex towards Kakinada facility could commence post the handover of the land parcel as the state government formalities are largely done. Divis expects the handover of the land to be during Q4FY22.

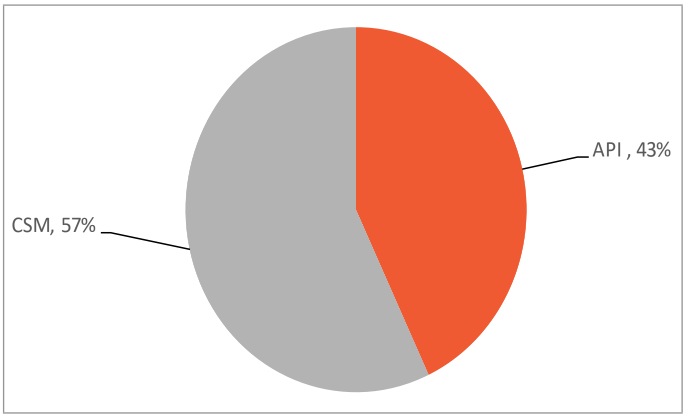
Financials in charts

Sales Trends (Rs Cr)



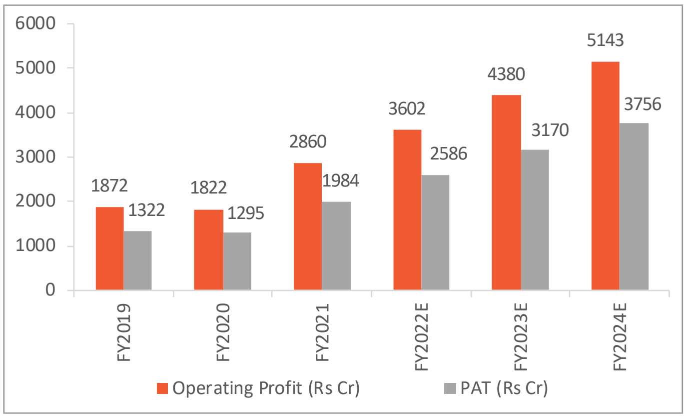
Source: Company, Sharekhan Research

Revenue Mix (% of sales)



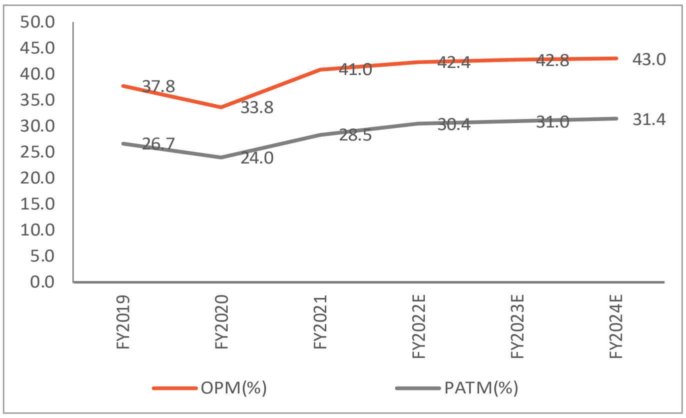
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



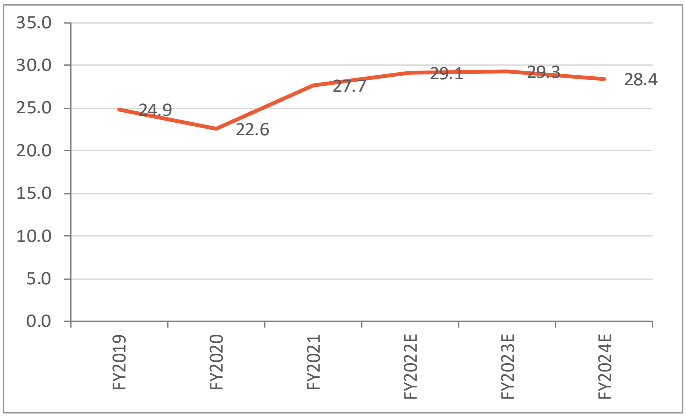
Source: Company, Sharekhan Research

Margin Trends



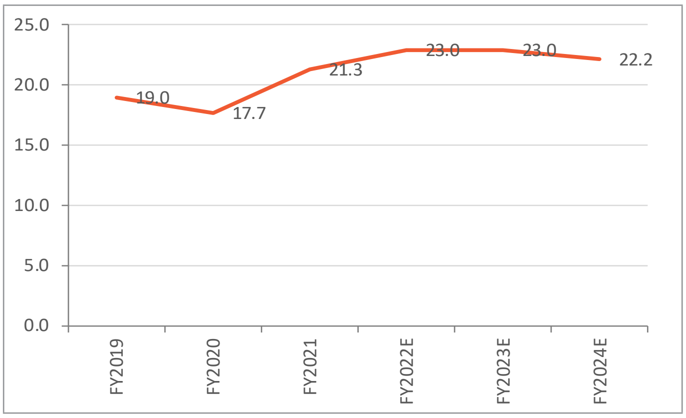
Source: Company, Sharekhan Research

RoCE Trend (%)



Source: Company, Sharekhan Research

Return ratios to improve



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector outlook – 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 pharmaceutical companies.

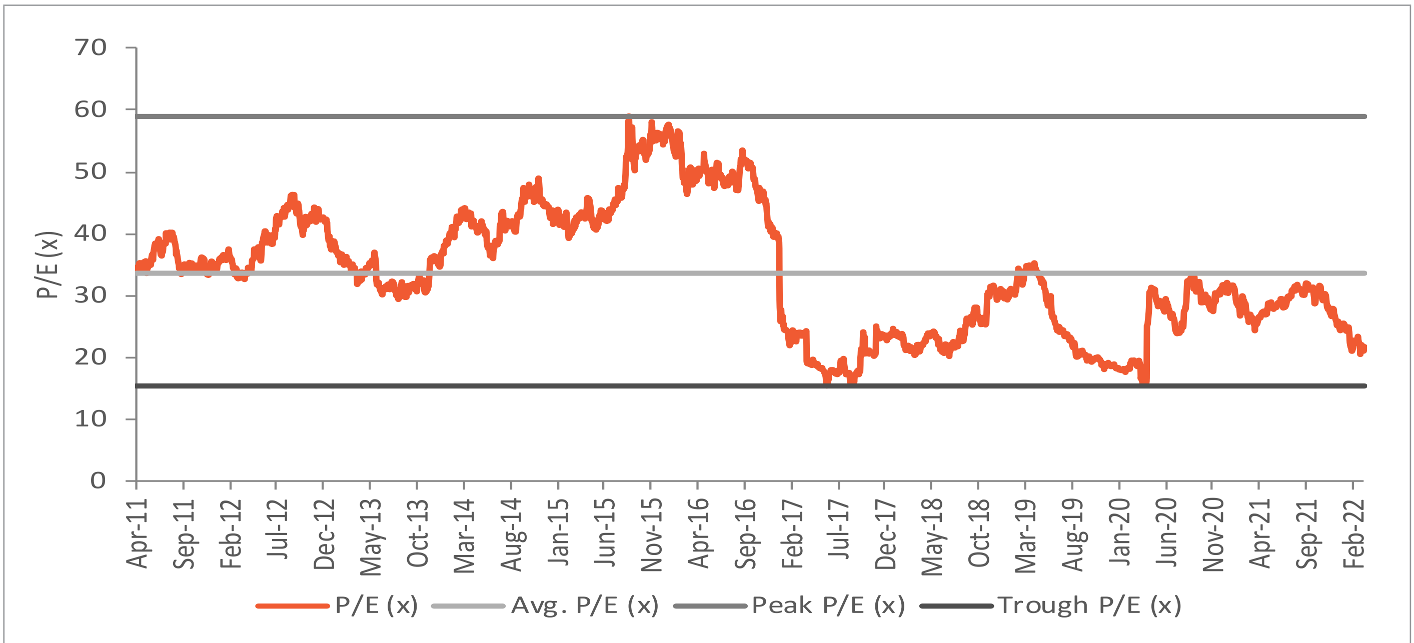
■ Company outlook – Strong earnings growth

Divis' long-term growth opportunities are robust, and the company is well-placed to capitalize 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. New areas of contrast media manufacturing and the next set of 10 molecules would complement growth going ahead. Consequently, the company has 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, Divis would be best placed to cater to increased demand. Moreover, the company has entered the contract media manufacturing space recently, 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. Moreover, the management has defined its six pillars or focus areas, which are expected to propel the company's growth in the times to come. The escalating costs could lead to margin pressures, though backward integration and expanded capacities would enable Divis to partly offset the same.

■ Valuation – Re-iterate Buy with unchanged PT of Rs. 5,620

Divis' growth prospects across its business stay bright and will propel the growth going ahead. These include growing existing molecules and market share gains from them, new areas of contrast media, expanding the offerings in the sartans (APIs), growing the custom synthesis business, and focus on products going off patent over the next two years. Further, tie up for Molnupiravir is also expected to open sizeable growth opportunity for Divis. Given its established capabilities, backward-integration, focus on quality, and benefits of scale coupled with major capacity expansion plans going on stream, the company is best-placed to cater to increasing demand from global big pharma companies. At CMP, the stock trades at rich valuations of 43.4x/35.4x/29.9x its FY22E/FY23E/FY24E EPS, respectively. Further the stock price has corrected by around 27% in over the past 5 months thus offering good opportunity for investors to enter the stock and hence we reiterate Buy recommendation on the stock with unchanged PT of Rs. 5,620.

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
Laurus Labs	555	53.2	29826	30.0	31.5	21.4	19.9	19.3	13.7	37.9	26.5	28.0
Divis Laboratories	4,233.0	26.5	1,12,367	56.6	43.4	35.4	37.7	29.5	23.9	21.3	23.0	23.0

Source: Company, Sharekhan estimates

About the 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 going on stream in FY2022 and , 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

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	1.7
4	GOVERNMENT PENSION FUND - GLOBAL	1.6
5	Reliance Capital Trustee Co	1.5
6	PineBridge Investments LP	1.1
7	Vangaurd Group Inc	1.1
8	BlackRock Inc	1.0
9	UTI Asset Management Company	0.9
10	HDFC Asset Management Company	0.9

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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