Sharekhan by BNP PARIBAS

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Divis Laboratories Limited

Stellar quarter; Robust outlook

Pharmaceuticals	Sharekhan code: DIVISLAB	Result Update

Stock Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 3,238**	
Price Target: **Rs. 3,800**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

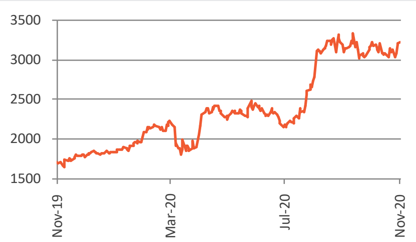
Company details

Market cap:	Rs. 85,951 cr
52-week high/low:	Rs. 3388 / 1627
NSE volume: (No of shares)	11.9 lakh
BSE code:	532488
NSE code:	DIVISLAB
Free float: (No of shares)	12.7 cr

Shareholding (%)

Promoters	52.0
FII	18.9
DII	18.8
Others	10.34

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.4	18.2	41.2	88.5
Relative to Sensex	-3.5	8.0	9.0	85.0

Sharekhan Research, Bloomberg

Summary

- Divis Laboratories Limited (Divis) reported impressive performance for yet another quarter with results ahead of estimates.
- Divis is witnessing improved demand traction across both its segments of API and custom synthesis business.
- In addition to the ongoing capex of Rs 1800 crore, Divis has announced Rs 400 crore of capex for the custom synthesis business. Also it has received an approval from the Government for Kakinada Greenfield. Sturdy capacity expansion plans would support growth going ahead.
- We expect Divis to benefit from backward-integration initiatives, large capex project and demand traction. We retain Buy recommendation on the stock with a revised PT of Rs. 3,800.

Divis Laboratories Limited (Divis) reported impressive numbers for yet another quarter with results ahead of estimates. A double digit growth in the API as well as custom Synthesis business drove the topline growth, while backward integration benefits and gross margin expansion drove the growth in operating margins, leading to a sturdy double digit earnings growth. Consolidated sales for the quarter stood at Rs. 1,749 crore, is up 21% y-o-y, due to 26% growth in API and 18% growth in custom synthesis business. OPM at 43.3% expanded sturdily by 933 bps y-o-y because of rise in gross margins and benefits of backward integration. Consequently, reported PAT at Rs. 519.6 crore was up 45.6% y-o-y and was ahead of estimates. Divis is witnessing a strong demand environment across both the API as well as custom synthesis business. There are immense opportunities that have emerged for API players such as Divis, as companies world over look to tide over the pandemic. Further, ongoing capacity expansion plans, which are expected to be completed by FY2021, provide ample visibility to cater to the increase in demand. Moreover, the company has received clearance for the Kakinada plant (envisaged capex is Rs. 600 crore) and expects work to commence over the next 2-3 months. Backed by a sturdy project inflow for the custom synthesis business, Divis has announced a Rs. 400 crore capex so as to capitalise on the opportunity. The fact that the company has lined up substantial investments towards capacity expansions points towards strong growth visibility. We believe Divis could also benefit from its backward-integration initiatives and planned new product launches. Sales and profit are expected to post at a sturdy 23%/33% CAGR over FY2020-FY2023.

Key Positives

- Revenue grew impressively by 21% y-o-y, aided by strong double-digit growth of 26% and 18%, respectively, across the API and custom synthesis business.
- OPM has expanded by sturdy 933 bps y-o-y to 43.3%, backed by gross margin expansion and benefits of backward integration.
- Rs. 400 crore announced for the custom synthesis business backed by strong order inflows.
- Received approvals for the Kakinada Greenfield, work to start by December 2020/January 2021.

Key Negatives

- Other income declined by 59.7% y-o-y to Rs. 14 crore, which is on the lower side around the past eight quarters.

Our Call

Valuation – Maintain Buy with a PT of Rs. 3,800: Divis is witnessing improved demand traction across its segments of API and custom synthesis business. To capitalise on these opportunities, the company is expanding its capacities across both these segments. Divis has announced a Rs. 400 crore capex plan for custom synthesis backed by strong orders from its customers. Moreover, the company expects to commence work on its Kakinada Greenfield as it has received approvals from the government. A sturdy capex plan points at a strong demand scenario and provides growth visibility. Q2FY2021 was a strong quarter for the company with sturdy all-around performance. Based on this, we have revised upwards our estimates by 6% and 7% for FY2022 and FY2023, respectively. At the CMP the stock trades at premium valuation of 34.3x / 28.2x its FY2022 / FY2023E EPS. We expect Divis to reap the benefits of backward integration, capacity expansion, and emerging opportunities in the API and custom synthesis space. Strong earnings visibility, almost zero debt, and strong return ratios bode well and provide visibility on sustenance of premium valuations. Moreover, the company does not have any pending regulatory hurdles, which is a key positive. We retain Buy recommendation on the stock with a revised PT of Rs. 3,800.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Net sales	4946.3	5394.4	6795.2	8554.1	10073.9
Operating Profits	1871.8	1822.2	2684.1	3421.6	4079.9
OPM (%)	37.8	33.8	39.5	40.0	40.5
PAT	1321.7	1294.5	1919.6	2506.5	3045.1
EPS (Rs.)	49.8	48.8	72.3	94.4	114.7
PER (x)	65.0	66.4	44.8	34.3	28.2
EV/EBIDTA (x)	43.1	44.5	30.4	23.5	19.3
ROCE (%)	24.9	22.6	27.9	29.1	28.2
RONW (%)	19.0	17.7	21.7	22.8	22.3

Source: Company; Sharekhan estimates

Impressive performance for Q2FY2021: Divis reported a stellar performance for Q2FY2021 with earnings ahead of ours as well as street estimates. Consolidated sales for the quarter reported growth of 21% y-o-y to Rs. 1,749 crore, backed by strong 26% growth in the generic API business, while the custom synthesis business grew by 18% y-o-y. Operating profit grew sharply by 54.3% y-o-y to Rs. 756.8 crore and was ahead of estimates. OPM grew by 933 bps y-o-y to 43.3% and was ahead of the estimated 36.2%. OPM expansion can be attributed to strong 810 bps expansion in gross margins, driven by product mix and benefits of backward integration. Moreover, adjusting for forex loss, other expenses (other expenses/sales) declined by 180 bps y-o-y. During the quarter, the company reported forex loss of Rs. 15.63 crore, as against gain of Rs. 13.17 crore reported in the corresponding quarter. Depreciation charge increased by 33% y-o-y as the company has capitalised its assets of Rs. 615 crore during the quarter. Consequently, reported PAT stood at Rs. 519.6 crore, up 45.6% y-o-y and is ahead of ours as well as street estimates.

Divis to benefit significantly from opportunities in API; Capacity expansion provides visibility: Divis is a leading player in the active pharmaceutical ingredients segment and derives around 60% of its revenue from the same. 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 the factors that have taken a 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 this. Moreover, substantial capacity expansion plan to be completed by the end of FY2021 provides ample visibility on the company's ability to meet incremental demand. In addition, Divis has been able to develop APIs/intermediates for few COVID-related products (Remdesivir and Favipiravir), which have been attracting strong demand. Although as of Q2FY2021, the contribution of these products is not substantial in total revenue, they offer a healthy growth potential as demand is likely to be higher at least in the near to medium term. In addition to this, the company has a strong product pipeline, which would unfold gradually as we move ahead. We expect the company's top line to grow by a sturdy 23% CAGR over FY2020-FY2023.

Divis announces Rs. 400 crore capex for custom synthesis backed by strong demand environment: The custom synthesis business has reported strong 18% growth for the quarter. 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. management has announced capex of Rs. 400 crore, which it plans to complete in the next 6-9 months. 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 believe the expanded capacities to start contributing to the revenue from FY2022, while full benefit from the same is likely to be reflected in FY2023.

Q2FY2021 Concall Highlights:

- **Substantial capacity expansion plans lined up:** Divis is in the midst of a Rs. 1,800 crore capex plan, which involves de-bottlenecking of existing plants as well as setting up new units. Divis will be investing Rs. 1,200 crore towards setting two units (Rs. 600 crore each). As of 1HFY2021, the company has capitalised Rs. 830 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. While the second one at DC Sez would be required to go through the regulatory approval process, which could take some time. In addition to the above, Divis has received clearance from the government for Kakinada plant and management looks to start construction work by December 2020 or January 2021 and expects another 2-3 years for the project to go on stream. Continuous capacity expansion plans lined up by the company would enable it to cater to the incremental demand.
- During Q2FY2021, the company's operations are now close to normal levels. Revenue from generic APIs stood at 60% of sales for Q2FY2021, while those from custom synthesis stood at 40%.
- Divis derives around 77% of its sales collectively from developed markets of US and Europe. The mix between generic APIs and custom synthesis segments stood at 59:41 for the quarter.
- De-bottlenecking measures are likely to increase capacity by 25%-30% and largely are completed.
- Divis is seeing a strong demand traction for custom synthesis business with new projects in hand from European clients. These projects are high-value projects and, hence, augur well for the company.
- As of September 2020, the company has cash and bank balance of around Rs. 1,869 crore on its books, receivables Rs. 1,572 crore, and stocks amounting to Rs. 1,699 crore.

Results Rs cr

Particulars	Q2FY21	Q2FY20	y-o-y (%)	Q1FY21	q-o-q (%)
Net revenue	1749.3	1445.6	21.0	1730.5	1.1
Operating profit	756.8	490.6	54.3	700.1	8.1
Other Income	13.6	33.9	(59.7)	12.5	8.9
Interest	0.2	3.8	(95.8)	0.2	(30.4)
Depreciation	61.1	45.9	33.1	56.2	8.8
PBT	709.1	474.7	49.4	656.2	8.1
Adj.PAT	535.2	343.6	55.8	487.3	9.8
Net PAT	519.6	356.8	45.6	492.1	5.6
Margins			**BPS**		**BPS**
OPM	43.3	33.9	933	40.5	281

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 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.

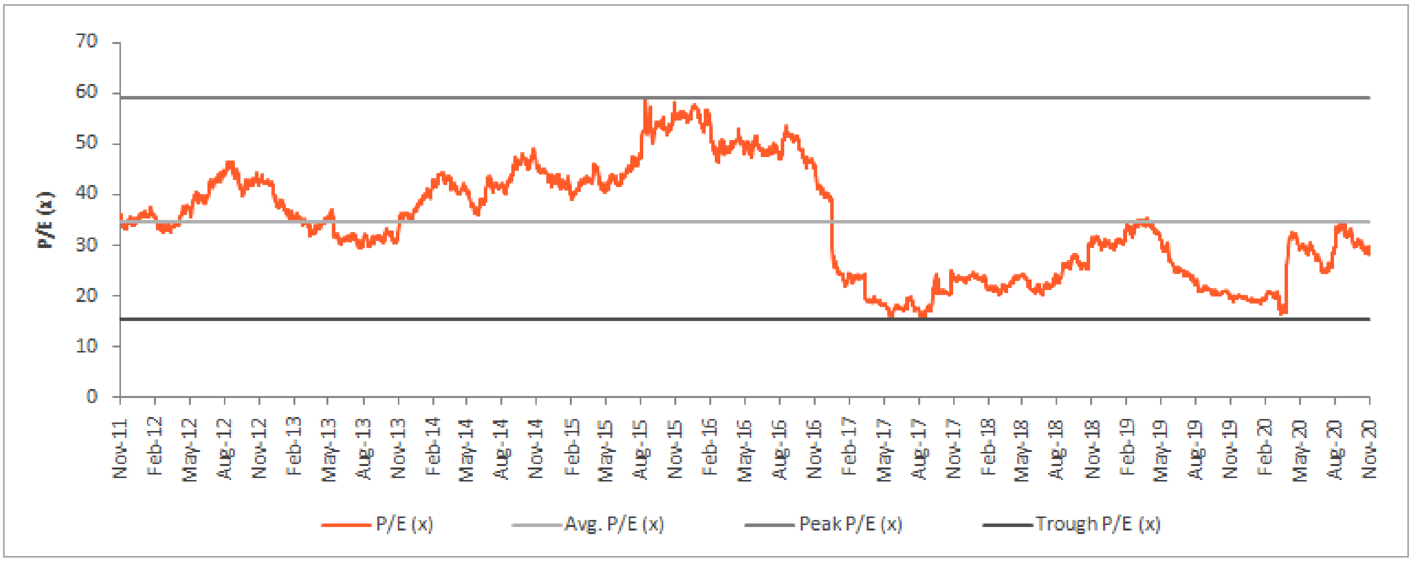
■ Company outlook - Robust earnings growth

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. 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 in stream by FY2022, Divis would be best placed to cater to increased demand.

■ Valuation - Maintain Buy with a PT of Rs. 3,800

Divis is witnessing improved demand traction across its segments of API and custom synthesis business. To capitalise on these opportunities, the company is expanding its capacities across both these segments. Divis has announced a Rs. 400 crore capex plan for custom synthesis backed by strong orders from its customers. Moreover, the company expects to commence work on its Kakinada Greenfield as it has received approvals from the government. A sturdy capex plan points at a strong demand scenario and provides growth visibility. Q2FY2021 was a strong quarter for the company with sturdy all-around performance. Based on this, we have revised upwards our estimates by 6% and 7% for FY2022 and FY2023, respectively. At the CMP the stock trades at premium valuation of 34.3x / 28.2x its FY2022 / FY2023E EPS. We expect Divis to reap the benefits of backward integration, capacity expansion, and emerging opportunities in the API and custom synthesis space. Strong earnings visibility, almost zero debt, and strong return ratios bode well and provide visibility on sustenance of premium valuations. Moreover, the company does not have any pending regulatory hurdles, which is a key positive. We retain Buy recommendation on the stock with a revised PT of Rs. 3,800.

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			EV / EBITDA			RoE (%)		
				FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
Solara Active Pharma	1,095.0	17.0	3,921.0	33.8	18.0	15.3	17.0	10.8	9.1	10.5	16.6	16.4
Divis Laboratories	3,238.0	26.5	85,951.0	66.4	44.8	34.3	44.5	30.4	23.5	17.7	21.7	22.8

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
N.V. Ramana	Executive Director
Dr. Kiran S. Divi	Whole time Director & CEO
Ms. Nilima Motaparti	Whole time Director – Commercial

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management Pvt Ltd	4.7
2	Axis Asset Management Co Ltd/India	3.0
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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