Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Divis Laboratories Ltd

Cost pressures stay elevated; long-term levers intact

Pharmaceuticals	Sharekhan code: DIVISLAB		
Reco/View: Buy ↔	CMP: Rs. 3,728	Price Target: Rs. 4,450 ↓	

↑ 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 17.86

Updated July 08, 2022

Low Risk

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

Source: Morningstar

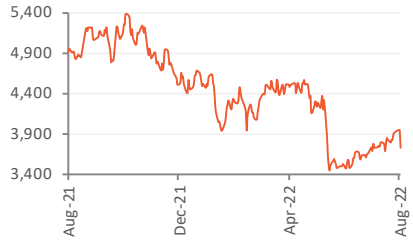
Company details

Market cap:	Rs. 98,972 cr
52-week high/low:	Rs. 5,425/3,365
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	-0.17	-11.9	-13.1	-24.1
Relative to Sensex	-8.1	-20.3	-12.9	-31.9

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy recommendation on the stock of Divis' Laboratories with a revised PT of Rs 4450.
- Divis Q1FY23 results were a mixed bag and reflected the higher operating costs while the lower tax rate resulted in a double-digit PAT growth and the results missed estimates
- Established capabilities, backward integration, focus on quality, and benefits of scale coupled with major capacity expansion plans commencing, are the positives that could support growth.
- The management commentary points to healthy demand, well supported by capacity expansion plans, which would drive top-line growth for the company, but elevated cost pressures will weigh on the performance in the coming quarters.

Divis Laboratories' (Divis) Q1FY23 results were a mixed bag and reflected the higher operating costs while lower tax rate resulted in a double-digit PAT growth. The revenue grew strongly in double digits backed by benefits from expanded capacities, the PAT due to lower tax rate too grew in double digits. The results missed estimates. The management commentary pointed at healthy demand, well supported by capacity expansion plans, which would drive top line growth for the company, however the management expects elevated cost pressures to sustain going ahead as overall costs including raw material, freight costs and power costs are at higher levels. This could weigh on performance in the subsequent quarters. Though Divis has implemented cost-control measures in the form of backward integration and de-bottlenecking of existing facilities and these could play out over the medium to long term.

Key positives

- Revenues grew by 15% y-o-y to Rs 2255 crore, which is strong growth momentum in challenging times.
- Benefits of operating leverage accruing due to a double-digit topline growth arrested the operating profit decline largely

Key negatives

- Gross margins shrunk by 330 bps y-o-y given the higher input cost pressures leading to a 590 bps y-o-y contraction in OPM's, which missed estimates

Management Commentary

- Divis' long-term growth levers are intact and the company is progressing well on these front to harness opportunities, which would propel growth.
- Elevated pricing pressures which include heightened raw material costs and freight costs, higher power costs, could be near-term dampeners. The management expects the cost pressures to sustain at least in the near to medium term going ahead.
- The Kakinada greenfield project has been delayed and the construction work is not yet commenced. Non-receipt of government clearance has caused the delay. Divis over the next 2-3 years has lined up capex plans of Rs 2000-3000 crore towards creating facilities / setting up new plants subject to receipt of regulatory approvals. Excluding the new facilities, Divis expects to invest ~ Rs 500 to 600 crore towards maintenance capex.

Revision in estimates – Divis Q1FY23 results were a mixed bag and reflected the higher operating costs while the lower tax rate resulted in a double-digit PAT growth and the results missed estimates. The operating margins contracted sharply by 590 bps y-o-y and the management commentary suggests of sustained pricing pressures going ahead. Basis this we have revised our FY23E and FY24E estimates down by 11% each.

Our Call

Valuation – Maintain Buy with revised PT of Rs. 4450: Divis' growth prospects across its business stay bright and will propel growth over the long term. Established capabilities, backward integration, focus on quality, and benefits of scale coupled with major capacity expansion plans commencing, are the positives that could support growth. However, given the cost headwinds including higher raw material costs, freight costs, and power costs, could overweigh on the performance in the near term. At CMP, the stock trades at valuations of 36.7x/31.9x its FY23E/FY24E EPS, respectively, while there are apparent near-term concerns, long-term growth levers are intact, hence we maintain a Buy recommendation on the stock with a revised PT of Rs 4450.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY2021	FY2022	FY2023E	FY2024E
Net sales	6969.4	8959.8	9203.9	10140.3
Operating Profits	2859.9	3881.9	3580.3	4086.5
OPM (%)	41.0	43.3	38.9	40.3
PAT	1984.3	2960.5	2694.0	3097.4
EPS (Rs)	74.8	111.5	101.5	116.7
PER (x)	49.9	33.4	36.7	31.9
EV/Ebidta (x)	33.1	24.1	25.4	21.7
ROCE (%)	27.7	30.3	23.7	23.2
RONW (%)	21.3	25.2	19.5	19.0

Source: Company; Sharekhan estimates

Operating performance miss estimates

Divis Q1FY23 results were a mixed bag and reflected the higher operating costs while the lower tax rate resulted idouble-digitigit PAT growth. The revenue though grew strongly in double digits backed by benefits from expanded capacities. The results missed estimates. The revenues at Rs 2254.5 cr grew by 15% y-o-y and was largely in line with the estimates. The benefits of expanded capacities and likely tractions in CSM business could have fuelled the topline growth. The operating margins at 37.6% contracted sharply by 590 bps y-o-y and missed estimates. A 330 bps y-o-y contraction in gross margins coupled with a 300 BPS increase in other expenses/sales resulted in an operating margin contraction. but a strong topline growth resulted in operating leverage and offset the impact of margins contraction, leading to a flat y-o-y growth in operating profits, which stood at Rs 847 cr. The tax rate for Q4 was lower at 18.8% v/s 32.4% in Q1FY22 and this coupled with operating leverage led to PAT coming in at Rs 645.6 cr, growth of 20.1% y-o-y, but missed estimates.

Q1FY2023 Concall Highlights

- **Long term Growth levers intact; near-term turbulence likely:** In the past, Divis has identified its long-term six growth engines and the management commentary suggests of healthy progress on these fronts. Divis' basket of established generics products in which the company has a market share in excess of 60-70 % is expected to sustain a double-digit growth trajectory. Secondly, the company is increasing the capacity for molecules in which it has a sizeable market share and offers room for further expansion (with strong growth potential) and through the capacity expansion, it plans to achieve a market share of 60-70% similar to established generics. Thirdly, based on the technical advantage towards areas of impurities in the Sartans, Divis plans to enter new areas of Sartans (for APIs). Moreover, Divis is looking at contrast media manufacturing as a key growth driver and is eyeing substantial contracts from big pharma players for the same, with the company doing its first filling in the contrast media space. Lastly, the company has shortlisted the drugs that are expected to go off-patent over the next two years which offer an approx. the addressable market size of $20 billion. Collectively, Divis plans to focus on these areas, identified as the six growth pillars are expected to propel the company's growth. However, given the existing pricing pressures in the developed US market, the demand trends from Divis customers could be under stress and this in turn could also impact the performance of the Generic APIs. This points to near-term challenges for the generic API segment.
- **Gross margins contract due to higher costs:** Divis' operating margins for Q1FY23 stood at 37.6%, which is a steep contraction of 590 bps y-o-y after series of quarters of consecutive margin expansion. Gross margins, contraction of 330 bps y-o-y attributable to high import costs due to energy cost increasing up by almost 30%, as well as pricing pressures or erosion in the US generics confronted by the customers, and higher raw material prices which in turn escalated cost pressures. The management sees the prices of certain solvents inching up by around 30-50% which is quiet steep. This points toward sustained cost pressures and the management expect the input costs pressures to sustain in the near term. While Divis is well-placed to combat these pressures through its levers - backward integration, de-bottlenecking of existing facilities and capacity expansion, which could play out in the medium to long term and support margins expansion, but given the apparent cost pressures the margins could be under stress in the subsequent quarters in the near term.
- **Capacity expansion plans:** In Q1FY2023, Divis has capitalized assets amounting to ~Rs. 87 crore and in FY22 has capitalized assets to the tune of Rs 935 crore. In the next 2-3 years, it plans to spend around Rs

2000 to RS 3000 crore which would be largely towards setting up greenfield capacities at Kakinada and Krishnapatnam port, with a focus to first expedite the Kakinada project. Further, in case of an opportuni,ty the capex spends could be increased to Rs. 4000-5000 crore as well. However, the capex towards Kakinada facility has been delayed due to the non-completion of government formalities. Once done the construction work on the same can commence. Until then the management has guided for maintenance capex of Rs 500-600 cr per year.

- **Revenue mix:** The Generic: CSM revenue mix stands at 47%:53% for Q1FY23 and the revenues from the nutraceutical business stand at Rs 186 cr v/s Rs 138 cr in Q1FY22.

Results (Consolidated) **Rs cr**

Particulars	Q1FY23	Q1FY22	Y-o-y(%)	Q4FY22	QoQ(%)
Net revenues	2254.5	1960.6	15.0	2518.4	(10.5)
Operating profit	846.7	852.1	(0.6)	1104.5	(23.3)
Other Income	32.0	16.3	95.9	21.2	50.7
EBIDTA	878.7	868.4	1.2	1125.7	(21.9)
Interest	0.1	0.3	(53.6)	0.1	62.5
Depreciation	83.7	73.3	14.2	81.0	3.3
PBT	794.9	794.8	0.0	1044.6	(23.9)
Tax Expense	149.3	257.4	(42.0)	181.1	(17.6)
Adj.PAT	645.6	537.5	20.1	863.5	(25.2)
Exceptional item	(56.4)	(19.6)	187.2	(31.2)	81.0
Net PAT	702.0	557.1	26.0	894.7	(21.5)
Margins(%)			**BPS**		**BPS**
OPM	37.6	43.5	-590	43.9	-630
Net Profit margin	31.1	28.4	272	35.5	-439
Tax rate	18.8	32.4	-1360	17.3	144

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 the commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for pharmaceutical companies.

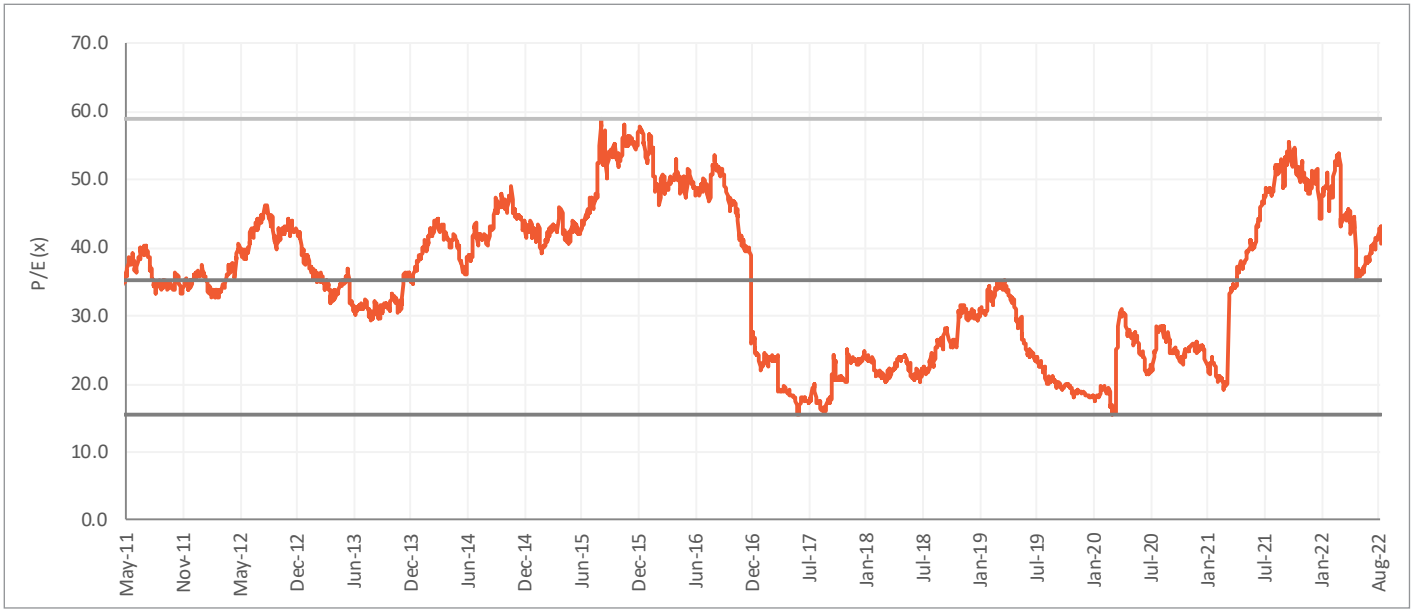
Company Outlook – Healthy earnings growth

Divis' long-term growth opportunities are robust and the company is well-placed to capitalize on the same. Similarly, growth levers in the generic API space are also promising over the long term, though concerns in the near term could drag growth. The hunt by global companies for alternative procurement sources for API/intermediates drugs is expected to benefit API-centric players such as Divis. New areas of contrast media manufacturing and focus on molecules going off patent in the next two years offering an addressable market size of $20 bn, could fuel the 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 going on stream, Divis could 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 in the near term, though backward integration and expanded capacities could be the long-term levers.

Valuation – Maintain Buy with revised PT of Rs.4,450

Divis' growth prospects across its business stay bright and will propel growth going ahead. These include growing existing molecules and market share gains from them, new areas of contrast media, expanding offerings in the sartans (APIs), growing the custom synthesis business, and focusing on products going off patent over the next two years. Given its established capabilities, backward integration, focus on quality, and benefits of scale coupled with major capacity expansion plans going on stream, are the positives that could support growth. However, the concerns like pricing pressures in the US generics markets and elevated cost pressures could overweigh on the performance in the near term. Divis Q1FY23 results were mixed bag and reflected the higher operating costs while the lower tax rate resulted in a double-digit PAT growth and the results missed estimates. The operating margins contracted sharply by 590 bps y-o-y and the management commentary suggests of sustained pricing pressures going ahead. Basis this we have revised our FY23E and FY24E estimates by 11% each. At CMP, the stock trades at valuations of 36.7x/31.9x its FY23E/FY24E EPS, respectively; while there apparent are near-term concerns, the long-term growth levers are intact. We maintain our Buy recommendation on the stock with a revised PT of Rs. 4450.

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 (%)		
				FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
Laurus Labs	573	53.2	30,766	36.2	24.6	18.7	22.4	15.2	11.8	24.8	26.7	26.1
Divis Laboratories	3,728	26.5	98,972	33.4	36.7	31.9	24.1	25.4	21.7	25.2	19.5	19.0

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 capitalize 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 sources 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 the stream by FY2022, Divis would be best placed to cater to increased demand.

Key Risks

- Adverse regulatory change
- Regulatory compliance risk
- 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	1.65
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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