



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

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

Source: Morningstar

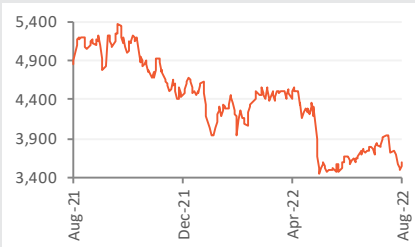
Company details

Market cap:	Rs. 95,227 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	-2.72	4.0	-13.2	-26.0
Relative to Sensex	-9.2	-4.4	-18.5	-31.1

Sharekhan Research, Bloomberg

Divis Laboratories Ltd

Near-term uncertainties apparent; long-term levers intact

Pharmaceuticals

Sharekhan code: DIVISLAB

Reco/View: Buy

↔

CMP: Rs. 3,587

Price Target: Rs. 4,450



Upgrade



Maintain



Downgrade

Summary

- We maintain our Buy recommendation on Divis Laboratories (Divis) with a unchanged PT of Rs. 4450.
- In its annual report for FY22, Divis has mentioned of the challenges confronted in FY22 on the back of Covid pandemic, unprecedented volatility in commodity costs, which impacted business across markets.
- Divis' long-term growth opportunities are robust and the company is well-placed to capitalize on the same. With expanded capacities going on stream, Divis could be best placed to cater to increased demand.
- Given the cost headwinds including higher raw material costs, freight costs, and power costs, could overweigh on the performance in the near term, though long term growth levers are intact.

In its annual report for FY22, Divis Laboratories (Divis) has mentioned of the challenges confronted in FY22 on the back of Covid pandemic, which impacted business across markets. Also the escalation of geopolitical conflict compounded the crisis and brought numerous other challenges in the form of strained trade relations, a steep increase in the inflation and unprecedented volatility in commodity costs. Though the pandemic posed challenges but it has also accelerated significant change in the healthcare ecosystem, making it more adaptable and innovative so as to with stand any sudden changes. Divis, basis its strong customer connects and capabilities has been able to benefit from the opportunities that has emerged. Further, Divis is better prepared to handle the evolving demand, continuous market volatility and an uncertain economic environment. The company plans to focus on the continuous process of innovation and green chemistry implementation to strengthen its overall position.

Global API Market to stage a 6% CAGR by 2030, bodes well for Divis: The global API market is expected to grow at 6% CAGR over 2022 – 2030, on the back of advancements in API manufacturing and the rising prevalence of chronic diseases. Favourable government policies for API production, favorable geo-political and trade conditions coupled with supply chain issues in China, provides significant growth opportunities for Indian API companies. Companies such as Divis with established capabilities and ample capacities have been a preferred partner for global Pharma majors and this bodes well from a growth perspective.

Resilient to adversity; outlines a six-point approach to propel growth: The pandemic led to uncertain market conditions had disrupted business across the globe, and Divis' had put in place a mechanism to emerge stronger from the adversity by adapting and accelerating despite disruptions and sustain its market leadership in API segment and also built capabilities in the custom synthesis space, so as to be able to cater to the increased customer demand. Further, Divis has come up with a six-point approach in an attempt to sustain the market leadership in the small molecule API segment.

Demand uncertainties, and elevated cost pressures transient in nature: While the long-term growth drivers for Divis are intact, in the near term there is a possible uncertainty with respect to demand. Price erosion is likely to impact the customers and this in turn could stress the demand from the customers in the near term. Also with the energy cost increasing by around 30% and prices of key raw materials including solvents rising in the range of 30% to 50%, are likely to elevate cost pressures and in turn, exert margin pressure in the near term. Management sees these as transient challenges and hence Divis' long-term growth levers are intact.

Our Call

Valuation – Long-term levers intact Maintain Buy: Divis in its annual report has mentioned transient challenges in the form of demand uncertainties and cost pressures, while the long-term growth prospects stay intact and could propel the growth. 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 35.3x/30.7x 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 unchanged PT of Rs 4450.

Key Risks

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

Valuation (Consolidated)

Particulars	FY2021	FY2022	FY2023E	FY2024E
Net sales	6969.4	8959.8	9203.9	10140.3
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)	48.0	32.2	35.3	30.7
EV/Ebitda (x)	31.8	23.1	24.4	20.8
ROCE (%)	27.7	30.3	23.7	23.2
RONW (%)	21.3	25.2	19.5	19.0
RONW (%)	21.3	25.2	19.5	19.0

Source: Company; Sharekhan estimates

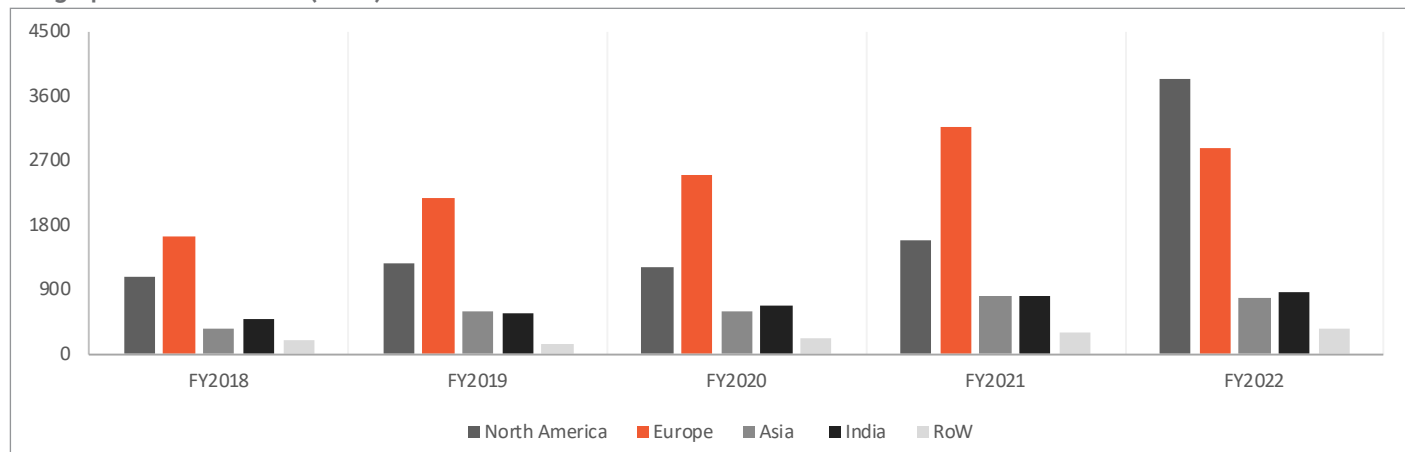
Key Highlights from Annual Report FY2022

In its annual report for FY22, Divis Laboratories (Divis) has mentioned of the challenges in FY2022 on the back of Covid pandemic, which impacted business across the globe and markets. Also the escalation of geopolitical conflict compounded the crisis and brought numerous other challenges in the form of strained trade relations, a steep increase in inflation, and unprecedented volatility in commodity costs. However the pandemic though posed challenges but it has also accelerated significant change in the healthcare ecosystem, making it more adaptable and innovative so as to withstand any sudden changes. Divis, basis its strong customer connections and capabilities has been able to benefit from the opportunities that emerged. In FY2022 the company not only created additional capacities, but also upgraded its utility infrastructure. Further, basis this, the company is better prepared to handle the evolving demand, continuous market volatility and an uncertain economic environment. The company plans to focus on continuous process innovation and Green chemistry implementation to further establish Divis as a strong sustainable organization and to deliver value-added performance.

Global API Market to stage a 6% CAGR over 2022-2030, bodes well for Divis

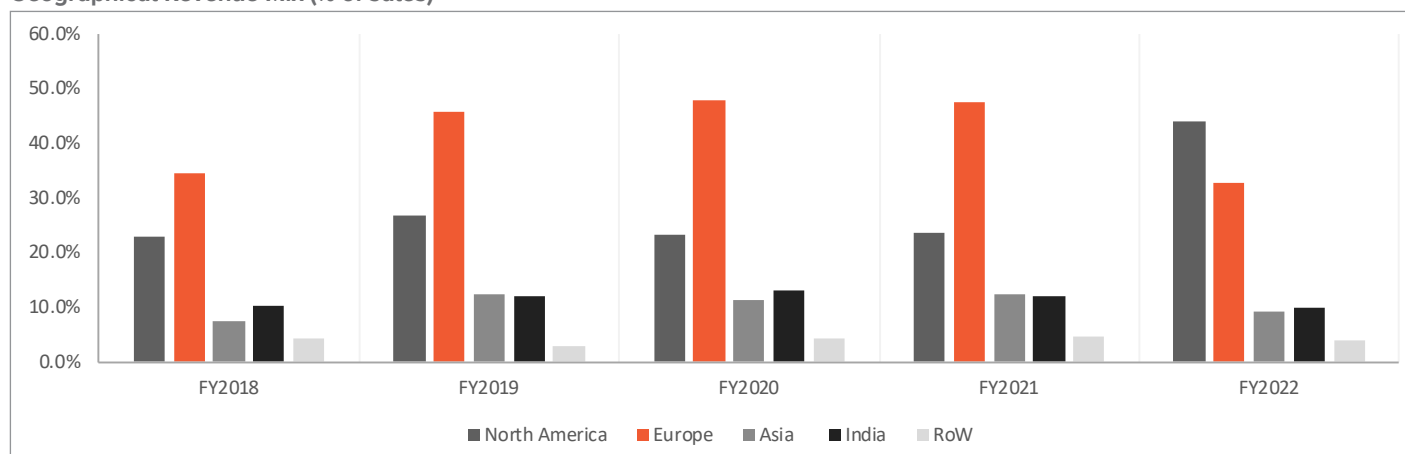
The global medicines market size is expected to touch \$1.8 trillion by 2026 translating to a CAGR of 3-6%, with most of the growth being driven largely by emerging markets, while the developed markets due to their higher base would look to sustain their growth momentum. In the developed markets, new brand spending is projected to generate incremental sales of \$195 bn by 2026 excluding novel therapeutics. There are expected to be 290-315 New Active substances launched by 2026, translating to an average of 54-63 new active substances per year, replicating the momentum sustained in the past five years. Therapy wise - Oncology, Immunology, Anti-diabetics, Neurology, Cardiology, Anti-coagulants, Respiratory & Pain will be the top 8 segments by value, and Oncology is projected to add 100 new treatments over five years. The generic share will rise, driven by, ongoing market dynamics around the use of medicines, the adoption of newer treatments, the impact of patent expiries, and new generic competition, which will all contribute to the market growth for the next five years. A growth in the medicines market could also have a rub-off effect on the API market growth. The global API market is expected to grow at 6% CAGR over 2022 – 2030, with the revenues expected to touch around USD 353 bn. The growth can be attributed to the advancements in API manufacturing and the rising prevalence of chronic diseases. Favorable government policies for API production, along with favorable changes in geopolitical conditions. Another important driver of growth for the API's is the supply chain issues in China which have benefited Indian API manufacturers by way of higher business as companies' world over look to reduce their dependence on China as a sourcing base. Companies such as Divis with established capabilities and ample capacities have been a preferred partner for global Pharma majors and this bodes well from a growth perspective.

Geographical Revenue Mix (Rs Cr)



Source: Company; Sharekhan Research

Geographical Revenue Mix (% of sales)

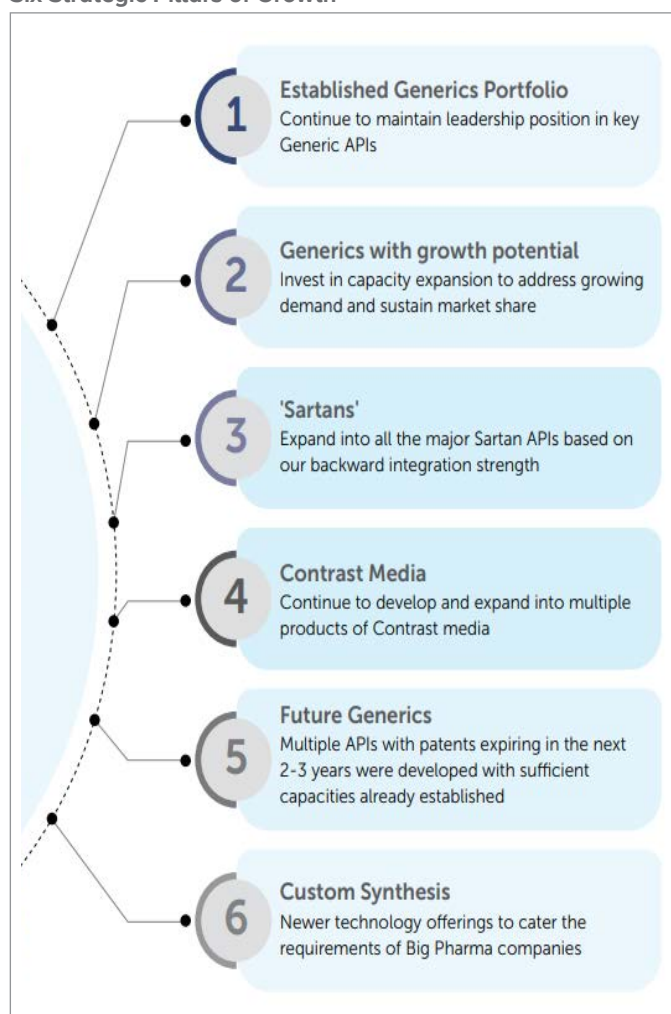


Source: Company; Sharekhan Research

Resilient to adversity; outlines a six-point approach to propel growth

The pandemic led uncertain market conditions had disrupted business across the globe, and Divis' had put in place a mechanism to emerge stronger from the adversity and sustain its market leadership in API segment and also built capabilities in the custom synthesis space. Divis has laid out six areas of focus, which are expected to drive the company's growth in the times to come. Divis' basket of established generics products in which the company has a market share in excess of 60-70 % is expected to sustain the growth trajectory. Secondly, the company is increasing the capacity for molecules in which it has around 30% market share and, through the capacity expansion, it plans to achieve a market share of 60% - 70% similar to established generics. Thirdly, based on technical advantage, areas of impurities in the Sartans, provides the company an edge over others. Hence, the company plans to enter areas of Sartans (for API). 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 that are expected to propel the company's growth over the long term. However, in the near term, 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.

Six Strategic Pillars of Growth

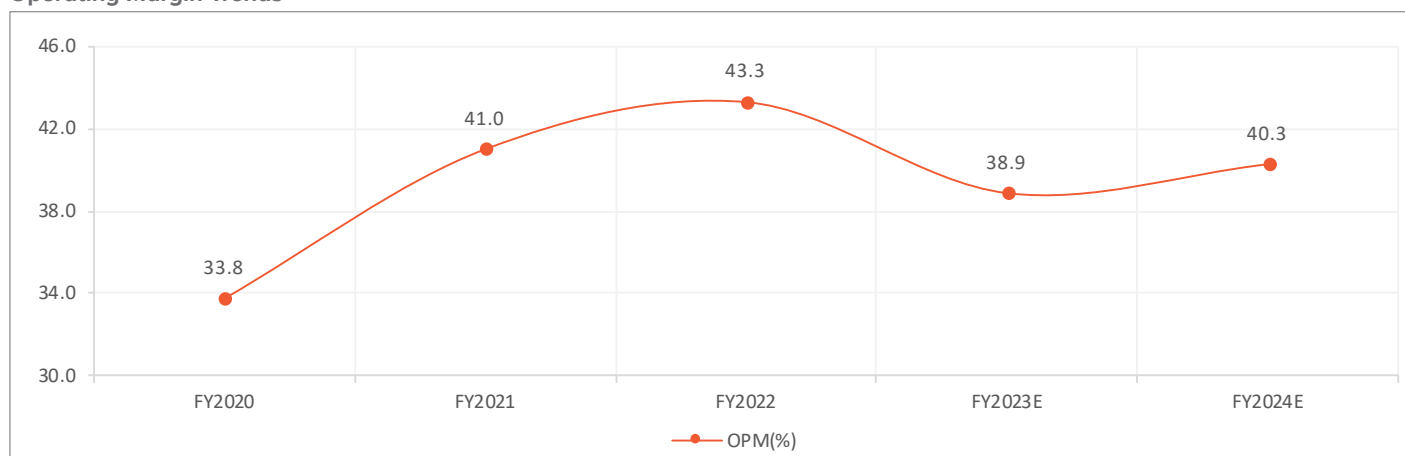


Source: Company; Sharekhan Research

Elevated costs pressures could exert margin pressures in the near term

Divis' Gross margins have contracted attributable to high import costs due to energy costs 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 increasing by around 30-50% which is quite a steep hike. This points toward sustained cost pressures and the management expect the input costs pressures to sustain in the near term. Also the management witnesses trade as well as economic turbulences which could hamper the margins performance, albeit 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 over the near term.

Operating Margin Trends



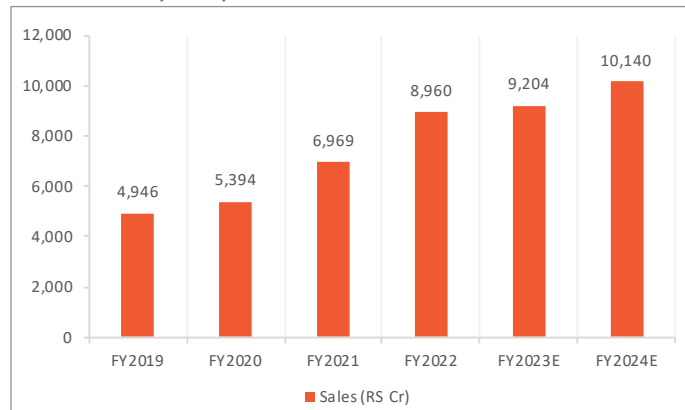
Source: Company; Sharekhan Research

Kakinada greenfield Capacity expansion plans

In FY2022 the company has capitalized assets worth Rs 934.5 crore and has reported a Capital work in progress of Rs 469.93 crore. In FY2022, Divis implemented several capacity expansion programs at its existing manufacturing facilities besides plant upgradation, augmenting the utility and support infrastructure. Further in Q1FY23, Divis has capitalized assets amounting to ~Rs. 87 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 opportunity 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-receipt of government approvals. Once the approvals are in place the construction work on the same can commence. Until then the management has guided for maintenance capex of Rs 500-600 cr per year as there is ample capacity available to cater to any emerging opportunity.

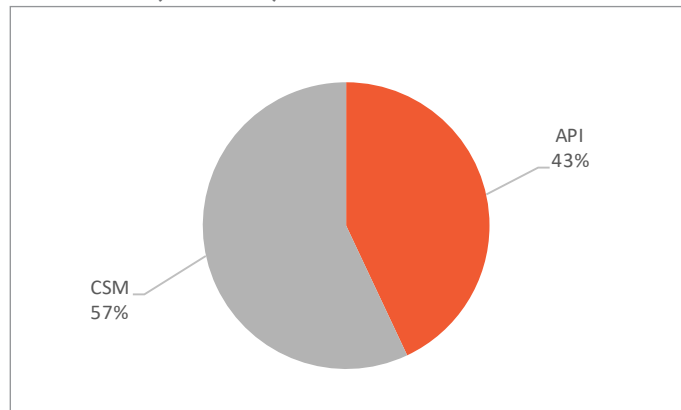
Financials in charts

Sales Trends (Rs Cr)



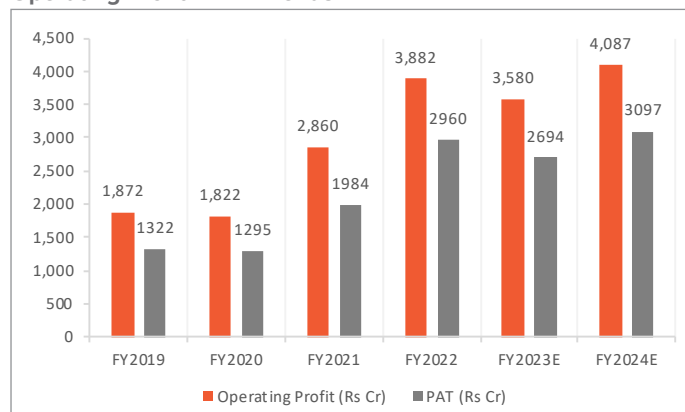
Source: Company, Sharekhan Research

Revenue Mix (% of sales)



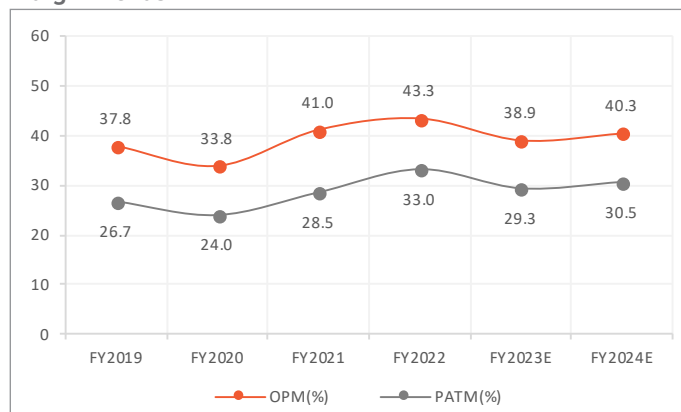
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



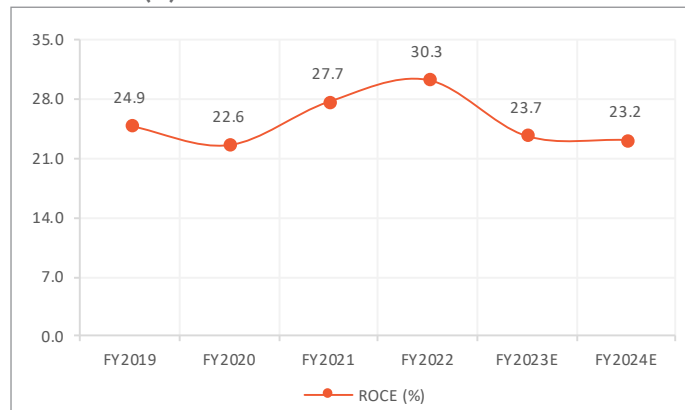
Source: Company, Sharekhan Research

Margin Trends



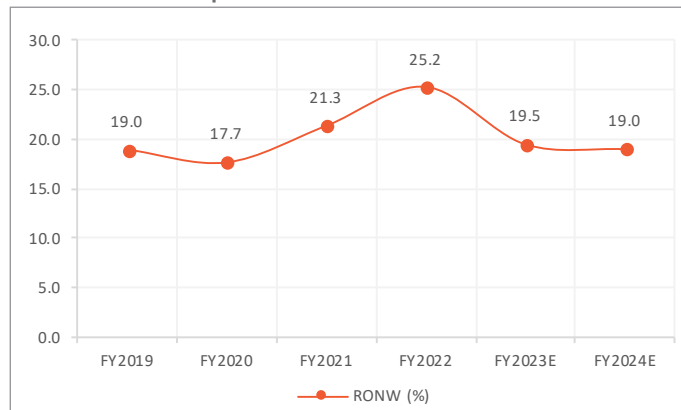
Source: Company, Sharekhan Research

RoCE Trend (%)



Source: Company, Sharekhan Research

Return ratios to improve



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Growth momentum to improve

Indian pharmaceutical companies are better placed to harness opportunities and report a 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 – Long-term levers intact Maintain Buy

Divis in its annual report has mentioned transient challenges in the form of demand uncertainties and cost pressures, while the long term growth prospects stay intact and could propel the growth. 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 35.3x/30.7x 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 unchanged 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	567	53.2	30,476	36.2	24.7	18.7	22.4	15.2	11.8	24.8	26.7	26.1
Divis Laboratories	3,587	26.5	95,227	32.2	35.3	30.7	23.1	24.4	20.8	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

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	1.65
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

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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 deteriorating 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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