Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Divi's Laboratories Ltd

Weak Q2; Near-term headwinds long-term levers intact

Pharmaceuticals	Sharekhan code: DIVISLAB
Reco/View: Buy ↔	CMP: **Rs. 3,298**
Price Target: **Rs. 3,975** ↓	

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- We maintain our Buy recommendation on Divis' Laboratories Limited (Divis) with a revised PT of Rs. 3,975. The stock has corrected by 23% in the past six months and is currently trading at 36.8x and 30.8x its FY2023E/FY2024E earnings.
- Divis registered weak performance in Q2FY2023 with revenue declining by 7% y-o-y to Rs. 1,854.3 crore and PAT down by 25% y-o-y to Rs. 463 crore.
- Established capabilities, backward integration, focus on quality, and benefits of scale coupled with major capacity expansion plans commencing are positives that could support growth in the long run.
- The company is working on measures to mitigate the cost pressures, which will help in gradual recovery in OPM in the coming years.

For Q2FY2023, Divis' Laboratories Limited (Divis) reported a 6.7% decline in revenue to Rs. 1,855 crore, which was way below our and average street expectation of Rs. 2,166 crore-2,191 crore. EBITDA margin at 33.5% contracted sharply by 803 bps y-o-y, led by a 343-bps y-o-y decline in gross margins coupled with higher employee and other expenses. EBITDA margin was much lower than our as well as street's expectation of 37.8-38.1%. A decline in revenue along with higher expenses led to a 20.6% y-o-y dip in EBITDA, which stood at Rs. 621 crore. Tracking the performance of EBITDA, adjusted PAT also declined by 24.6% y-o-y to Rs. 463 crore. Management commentary pointed at healthy demand, well supported by capacity expansion plans, which would drive the company's topline growth. However, management expects margins will take some time to recover. The company 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

- Gross margins remain stable at 64% on a sequential basis.

Key negatives

- Consolidated revenue decreased by ~7% y-o-y to Rs. 1,854.5 crore.
- OPM decreased by 803 BPS y-o-y to 33.5%; operating profit declined by 25% y-o-y.

Management Commentary

- Divis' long-term growth levers are intact and the company is progressing well on these fronts to harness opportunities, which would propel growth.
- The company plans to focus on newer APIs worth USD 20 bn, which is expected to go off patent in FY2023-FY2025. On custom synthesis, management indicated that US and EU do not have enough capacities to produce the newer off-patent drugs, which will provide immense opportunity for Indian drug makers in the coming years.
- The company is awaiting final clearance from the government for its Kakinada's plant. It will take 2-3 years for the company to capitalise revenue from the plant post approval.

Revision in estimates – We have reduced our earnings estimates for FY2023 and FY2024 to factor in the weak performance in Q2FY2023.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 3,975: 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, cost headwinds including higher raw-material costs, freight costs, and power costs could overweigh on the performance in the near term. Post the recent correction in the stock price, it trades at attractive valuations of 36.8x/30.8x its FY2023E/FY2024E EPS, respectively. In view of its long-term growth prospects, we maintain our Buy recommendation on the stock with a revised price target (PT) of Rs. 3,975.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E	FY25E
Net sales	6969.4	8959.8	8183.9	9356.8	10311.7
OPM (%)	41.0	43.3	38.9	40.3	40.6
PAT	1984.3	2960.5	2376.6	2844.8	3178.2
EPS (Rs)	74.8	111.5	89.5	107.2	119.7
PER (x)	44.1	29.6	36.8	30.8	27.5
EV/EBITDA (x)	29.2	21.2	25.0	20.6	18.1
ROCE (%)	27.7	30.3	21.4	22.0	21.3
RONW (%)	21.3	25.2	17.6	18.1	17.4

Source: Company; Sharekhan estimates

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 Oct 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. 95,227 cr
52-week high/low:	Rs. 5091 / 3275
NSE volume: (No of shares)	5.5 lakh
BSE code:	532488
NSE code:	DIVISLAB
Free float: (No of shares)	12.8 cr

Shareholding (%)

Promoters	51.9
FII	16.0
DII	20.8
Others	11.24

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-10.5	-16.5	-23.2	-33.4
Relative to Sensex	-15.8	-19.3	-36.0	-34.4

Sharekhan Research, Bloomberg

Weak Q2; Miss on all fronts

The company's revenue at Rs. 1,855 crore declined by 6.7% y-o-y and was way below our and average street expectation of Rs. 2,166 crore-2,191 crore. EBITDA margin at 33.5% contracted sharply by 803 bps y-o-y, led by a 343-bps y-o-y decline in gross margins coupled with higher employee and other expenses. EBITDA margin was much lower than our as well as street's expectation of 37.8-38.1%. A decline in revenue along with higher expenses led to a 20.6% y-o-y dip in EBITDA, which stood at Rs. 621 crore. Tracking the performance of EBITDA, adjusted PAT also declined by 24.6% y-o-y to Rs. 463 crore, significantly lower than our and average street estimates of Rs. 614 crore-620 crore.

Key conference call highlights

- **Gradual improvement in gross margins expected:** Gross margins have largely remained similar on a y-o-y basis despite high raw-material, energy, and logistics costs. Though freight cost and air cost have come down, the company still sees some upward pressure in the near term from raw materials, especially prices of some metals such as lithium and Iodine as well as elements like bromine. Overall, raw-material supply issues have stabilised.
- **Future capex will depend on the requirement of key businesses:** The company's backward-integration projects have helped the company reduce its dependence from China by ~20% y-o-y in H1FY2023. The current overall capacity utilisation stands at 80-83%. The Nutra biz capacity utilisation stands at ~80%. Further, capex depends on requirements of the new fast-track projects and new MRI-related contract media opportunities. Kakinad plant is yet to get final clearance from the government for its construction.
- **Custom synthesis business (accounted for 43% of revenue):** Business sales decreased by 38% y-o-y to Rs. 797 crore amid loss of Covid opportunity. Excluding the Covid opportunity, sales of the custom synthesis business fell by 39% y-o-y/25% q-o-q due to ongoing challenges in European markets. However, the company is more optimistic on the custom synthesis business now because of multiple Ph-III projects with big pharma companies progressing for commercial supplies in 4-6 quarters along with steady progress in its early-stage normal developmental supplies. Moreover, Divis expects healthy contribution from Big Pharma for two contrast media and two Sartan projects in the near future.
- **API Business** – The company has multiple DMFs in various regulated markets. The contract media API is in qualification stages with customers. Two are specifically for innovators/leaders in this space. There are two types of contrast media. One is for CT scans and the second is for MRIs, where the company has just entered and is a much bigger market. Acute therapy APIs have shown growth. The company plans to focus on newer APIs worth USD20 bn, which is expected to go off patent in FY2023-FY2025.
- **Nutra business remains under pressure:** The nutra business is still facing pricing pressure. One of the competitors in this business is exiting the market and management is confident that it will be able to capitalise on this opportunity and gain market share. Divis has the capacity as well as additional capacity will be added to smoothen this process.
- **On Sartans**, the company is backward integrated. The company uses photochemistry to produce RMs, which is a key differentiator as it is used in all Sartans. The company is a leader in two Sartans. The company has a CDMO project for Sartans, where qualification is complete. Another CDMO project for a big pharma company for Sartan is going on as commercial quantities are currently being manufactured. The company also believes that the custom synthesis business creates a big opportunity and will look to capitalise on it.

Results (Consolidated) Rs cr

Particulars	Q2FY23	Q2FY22	YoY(%)	Q1FY23	QoQ(%)
Net revenues	**1854.5**	**1987.5**	**(6.7)**	**2254.5**	**(17.7)**
RM Cost	674.6	654.8	3.0	812.0	(16.9)
Total operating expenditure	1233.5	1162.3	6.1	1407.8	(12.4)
Operating profit	**621.0**	**825.2**	**(24.7)**	**846.7**	**(26.7)**
Other Income	49.3	19.1	157.7	32.0	54.0
EBIDTA	670.3	844.3	(20.6)	878.7	(23.7)
Interest	0.2	0.2	(19.0)	0.1	30.8
Depreciation	85.7	77.4	10.8	83.7	2.5
PBT	584.4	766.7	(23.8)	794.9	(26.5)
Tax Expense	121.6	153.2	(20.6)	149.3	(18.5)
Adj.PAT	**462.8**	**613.6**	**(24.6)**	**645.6**	**(28.3)**
Exceptional item	(30.8)	7.1	-	(56.4)	(45.3)
Net PAT	493.6	606.5	(18.6)	702.0	(29.7)
			BPS		**BPS**
GPM	63.6	67.1	-343	64.0	-36
OPM	33.5	41.5	-803	37.6	-407
Net Profit margin	26.6	30.5	-390	31.1	-452
Tax rate	20.8	20.0	84	18.8	203

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.

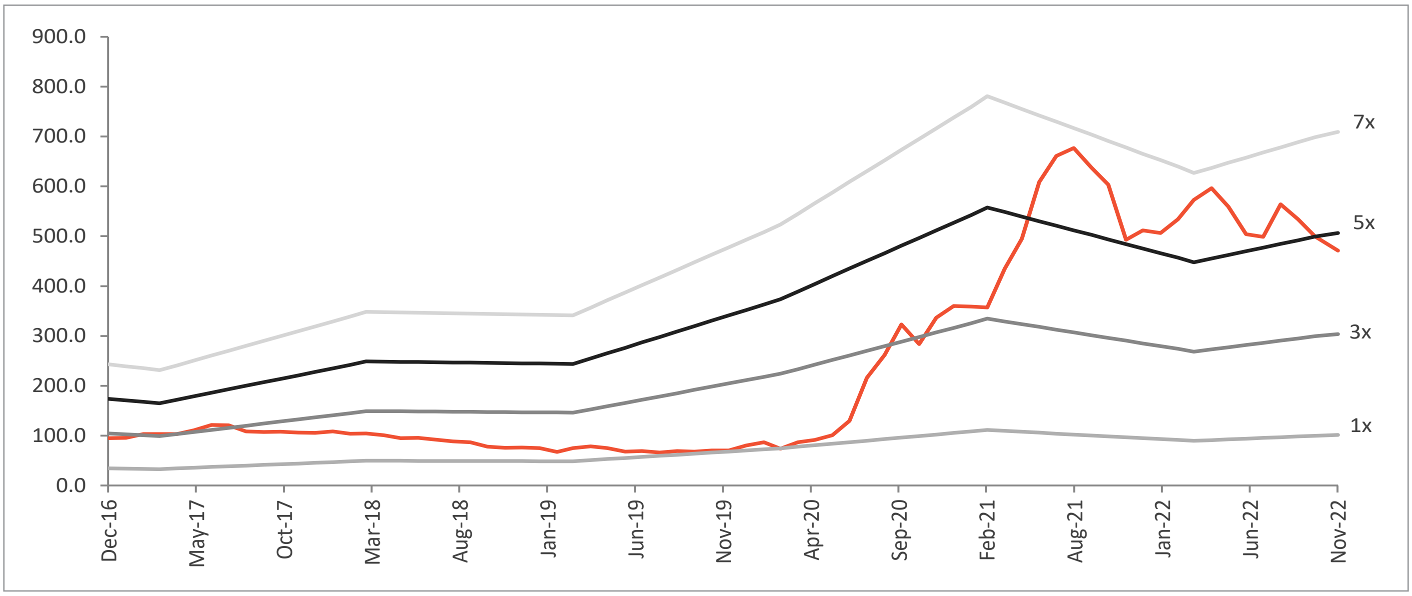
■ Company outlook - Healthy earnings growth

Divis' long-term growth opportunities are robust and the company is well placed to capitalise 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, management has defined its six pillars or focus areas, which are expected to propel the company's growth in the times to come. Escalating costs could lead to margin pressures in the near term, though backward integration and expanded capacities could be long-term levers.

■ Valuation - Maintain Buy with revised PT of Rs. 3,975

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, cost headwinds including higher raw-material costs, freight costs, and power costs could overweigh on the performance in the near term. Post the recent correction in the stock price, it trades at attractive valuations of 36.8x/30.7x its FY2023E/FY2024E EPS, respectively. In view of its long-term growth prospects, we maintain our Buy recommendation on the stock with a revised PT of Rs. 3,975.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Companies	CMP (Rs / Share)	O/S Shares (Crs)	Mcap (Rs Cr)	P/E (x)			EV / EBITDA (x)			RoE (%)		
				FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
Laurus Labs	450.9	53.7	24,230	28.8	23.0	20.0	18.1	13.7	11.7	24.8	23.7	21.4
Divis Laboratories	3,298.0	26.5	87,552	29.6	36.8	30.8	21.2	25.0	20.6	25.2	17.6	18.1

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 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 on 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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management	6.52
2	Life Insurance Corp India	3.71
3	Axis Asset Management	3.53
4	BlackRock Inc	1.63
5	Vanguard Group Inc.	1.60
6	Government Pensi	1.32
7	Norges Bank	1.31
8	UTI AMC	0.97
9	Pine Bridge Investments	0.71
10	Nippon Life India Asset Management	0.65

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

Sharekhan

by BNP PARIBAS

Know more about our products and services

For Private Circulation only

Compliance Officer: Ms. Binkle Oza; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com.

Registered Office: Sharekhan Limited, The Ruby, 18th Floor, 29 Senapati Bapat Marg, Dadar (West), Mumbai – 400 028, Maharashtra, INDIA, Tel: 022 - 67502000/ Fax: 022 - 24327343. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O/ CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183.