Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Divi's Laboratories Ltd

Weak quarter, headwinds to persist

Pharmaceuticals	Sharekhan code: DIVISLAB	
Reco/View: Hold ↓	CMP: Rs. 2,884	Price Target: Rs. 3,168 ↓

↑ 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 Dec 08, 2022

Low Risk

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

Source: Morningstar

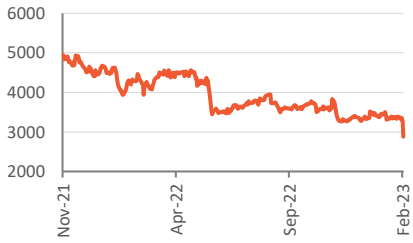
Company details

Market cap:	Rs. 76,570 cr
52-week high/low:	Rs. 4,641 / 2,795
NSE volume: (No of shares)	3.3 lakh
BSE code:	532488
NSE code:	DIVISLAB
Free float: (No of shares)	12.8 cr

Shareholding (%)

Promoters	51.9
FII	15.2
DII	20.7
Others	12.2

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-4.00	-3.41	-16.24	-22.62
Relative to Sensex	-5.90	-3.20	-19.90	-26.40

Sharekhan Research, Bloomberg

Summary

- We downgrade our Buy rating on Divis Laboratories (Divis) to Hold with a revised PT of Rs 3,168. The stock has corrected by 33.2% in last one year, at current levels also valuation looks rich at 35.0x and 29.1x its FY2024/25E earnings.
- Numbers are weak and failed to meet even our and street modest estimates, on all fronts in Q3FY2023.
- Divis' registered weak performance in Q3FY2023 with revenues declining by a massive 31.5% yoy to Rs 1,708 crore and PAT declining by 66.0% y-o-y to Rs. 307 crore.
- Margins are expected to lag behind historical averages and normalize by FY25/26, as sales improve from new product opportunities in custom synthesis and contrast media APIs.

Divis underperformed hugely in Q3FY2023 on all fronts, which may continue over the next few quarters. Revenues at Rs. 1,708 crore declined by 31.5% y-o-y and was way below our and average street expectation of Rs. 1,937-2,493 crore. EBITDA margins at 23.9% contracted sharply by 2.02% points y-o-y to 23.9% (vs. internal estimate of 34.0%), led by a 996-bps y-o-y decline in the gross margins to 56.7% coupled with almost flat employee and other expenses y-o-y. A decline in revenues and a sharp decline in the margins led to a huge 71.3% y-o-y decline in the adjusted PAT to Rs. 260 crore (vs. internal estimate of Rs. 487 crore and street estimate of Rs. 494 crore) and 66.0% y-o-y decline in PAT to Rs. 307 crore. The management commentary indicates likely resumption in revenue growth and margin expansion only by FY2025.

Key negatives

- The company underperformed massively by an average 30% rate from internal and consensus estimates on all fronts.
- OPM decreased by 2.02% points y-o-y to 23.9%
- Reported PAT declined by 66.1% y-o-y to Rs. 306.8 crore.

Management Commentary

- After having the opportunity to service COVID products last year, the normalisation is visible in its core API portfolio of products.
- As the sales increase the operating leverage would be more favorable by FY2025.
- FY2025 looks to be the year in which most of the growth driving projects to start commercializing. The company is not likely to reach 40% kind of EBITDA margins over the next two years. As volumes will improve, the company expects the pricing to follow suit.
- The Kakinada Unit III facility has received the necessary government clearances and the company is to update on it in the coming quarters. The company is underway with finalizing plans (to be built at Rs. 1,000 Cr.) In the next couple of quarters, the construction should go on in the full swing. Likely be commissioned over the next 2-3 years.

Revision in estimates – We have reduced our earnings estimates for FY2024 and FY2025 to factor in the weak Q3FY2023 and softer growth outlook. We estimate its sales to grow at 2.8% CAGR (vs. earlier estimate of 4.8% CAGR and earnings to grow at (-3.9%) (vs. earlier estimate of 2.4% CAGR) over FY2023-FY2025E.

Our Call

Valuation – Downgrade to Hold with revised PT of Rs. 3,168: The company has been witnessing adverse products mix in favour of low-margin generic APIs (60% of revenue) while its high margin custom synthesis business (40% of revenue) has been falling y-o-y over the last two quarters after COVID 19 API opportunity tapers down. The company does not expect strong revenue growth to resume before FY2025-FY2026 with Contrast Media and Custom Synthesis business opportunities commercializing, which remain in the pipeline. With slower revenue growth and adverse products mix likely over short to medium term while few raw materials costs are expected to continue to trend higher, the profitability is not expected to resume back to historical levels, before FY2025-FY2026. At the same time, despite the recent correction in the stock price, the stock is trading at an expensive valuation of 35.0x/29.1x its FY24E/FY25E revised EPS estimates, respectively. Hence, we downgrade our Buy recommendation on it to Hold with a revised PT of Rs. 3,168.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY2021	FY2022	FY2023E	FY2024E	FY2025E
Net sales	6969.4	8959.8	7688.4	8538.0	9741.9
OPM (%)	41.0	43.3	31.5	33.3	35.0
PAT	1984.3	2960.5	1952.3	2189.1	2627.7
EPS (Rs)	74.8	111.5	73.5	82.5	99.0
PER (x)	38.6	25.9	39.2	35.0	29.1
EV/Ebidta (x)	25.5	18.5	25.5	21.4	17.7
ROCE (%)	27.7	30.3	18.4	19.4	20.5
RONW (%)	21.3	25.2	14.9	15.0	15.8

Source: Company; Sharekhan estimates

Weak quarter; miss on all fronts

Revenues at Rs. 1,708 crore, declined by 31.5% y-o-y and was way below our and average street expectation of Rs. 1,937-2,493 crore. EBITDA margin at 23.9% contracted sharply by 2.02% points y-o-y led by a massive 996 bps y-o-y decline in the gross margins to 56.7% while employee and other expenses remained almost flat, y-o-y. EBITDA margins were much lower than ours as well as street expectation of 34-35%. A decline in revenue and adverse products mix led to a huge 62.9% y-o-y decline in EBITDA, which stood at Rs. 408 crore. Tracking the performance of EBITDA, adjusted PAT also declined by a huge 71.3% y-o-y to Rs. 260 crore, significantly lower than our and street estimates of ~ Rs. 490 crore..

Key conference call highlights

- **Operations are normalising:** Manufacturing operations have been running smoothly despite global market scenarios including the global recession and geopolitical concerns. There were no disruption to the customer's shipments during Q3FY2023. The company is fulfilling the requirements of all the customers on time. The global logistics scenario improved q-o-q due to improvement in sea and air freight costs. However, the company continues to witness manpower shortages. The company is conscious of inbound and outbound logistics management to keep operations smooth.
- **Costs a mixed bag:** Raw materials costs availability and costs have stabilized while prices have slightly softened QoQ. However, the prices of some base metals such as Lithium and Iodine have increased over the last few quarters and expects this trend to continue. The company is also monitoring energy costs. The company is diversifying its supply base to reduce its supply chain risks.
- **Core API portfolio normalising:** After having the opportunity to service covid products last year, the normalization is visible in its core API portfolio of products, which is growing. With new products opportunities, it is expected to grow further. The company has implemented various strategies to ensure uninterrupted supply and maintain normal operations despite a COVID surge in various parts of the world. The company continues to maintain leadership position in its core generic products. Its top core generic products continue to grow. This growth is driven by volumes despite pricing pressure.
- **Key financials:** The company has capitalized Rs. 275 crore in 9MFY2023. Capital WIP was Rs. 575 Crore, as of Q3FY2023. Materials consumption for Q3FY2023 was 43% of sales due to change in products mix. The effective tax rate was 29% for Q3FY2023. For 9MFY2023 revenue was Rs. 6,100 crore and PAT was Rs. 1502 Cr. Exports were at 87% of the revenue and the revenue from the US and Europe stood at 69% of revenue in Q3FY2023 and 70% for 9MFY2023. Products mix to Generics to custom synthesis is 60%:40% for Q3FY2023. As the company has a lower sales revenue in Q3FY2023, constant currency growth (CCG) for the quarter has been (-) 40% for Q3FY2023 and (-) 17% for 9MFY2023 period. Nutraceuticals revenue stood at Rs. 150 crore for Q3FY2023 and Rs. 509 crore for 9MFY2023. As of Q3FY2023, the company has cash on books of Rs. 3,849 crore, receivables of Rs. 1,669 crore and inventory of Rs. 2,981 crore.
- **Kakinada capex:** The Kakinada Unit III facility has received the necessary government clearances and the company is to update on it in the coming quarters. The company is underway with finalising the plans (at the total cost of Rs. 1,000 crore). In the next couple of quarters, the construction should go in the full swing. The facility is likely to be commissioned over the next 2-3 years.
- **Guidance:** As the sales increase the operating leverage would be more favorable by FY2025, which looks to be the year in which most of the growth driving projects to start commercialising. Not to reach 40% kind of EBITDA margins over the next 2 years. As volumes will improve the company expects the pricing to follow suit. The new generic and contrast media API pricing should be better in the coming quarters.
  - Divis plans to invest in new technologies such as continuous flow chemistry etc. and new compounds. There is a good demand for contrast media. Contrast Media APIs and Custom synthesis is likely to go in shipment from Q1FY2024.
  - Double-digit growth seen in generics. Products are expanding as well. To expect good volumes growth in generics.

- Gross margins were also hurt also because some of the high-cost inventory for inputs was there especially for Lithium etc. but the prices are coming down q-o-q. Expects better margins in the coming quarters.
- Pricing pressure across industry. RM costs are improving and so are volumes q-o-q, so should help profitability.
- Capacity utilization is at 77% and growth engines will be the products for whom the qualifications are done.
- Volumes growth would continue in the coming quarters, which has been impacted by the pricing pressures in nutraceuticals and generics business.

- **Custom synthesis -** has no pricing pressure from big pharma but raw materials costs was a concern. QoQ, the contracts are negotiated and is a function of demand from customers.

Results (Consolidated) **Rs cr**

Particulars	Q3FY23	Q3FY22	Y-o-Y %	Q2FY23	Q-o-Q %
Net revenues	1,708	2,493.2	-31.5	1,854.5	-7.9
RM Cost	740	831.6	-11.1	674.6	9.6
Total operating expenditure	560	561.4	-0.3	558.9	0.2
EBIDTA	408	1,100.3	-62.9	621.0	-34.3
Depreciation	87	79.9	8.6	85.7	1.2
Operating profit	322	1,020.4	-68.5	535.3	-39.9
Interest	0	0.2	-43.5	0.2	-23.5
Other Income	68	16.6	306.7	49.3	37.3
PBT	389	1,036.8	-62.5	584.4	-33.4
Tax Expense	129	131.4	-2.0	121.6	5.9
Adj. PAT	260	905.3	-71.3	462.8	-43.8
Exceptional item	-47	3.1	NM	-30.8	51.3
Net PAT	307	902.2	-66.0	493.6	-37.8
Margins(%)			**BPS**		**BPS**
GPM	56.7	66.6	-996	63.6	-693
EBITDA margin	23.9	44.1	-2022	33.5	-958
Adj. NPM margin	15.2	36.3	-2108	25.0	-972
Net Profit margin	18.0	36.2	-1822	26.6	-865
Tax rate	33.1	12.7	2044	20.8	1,231

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View - Multiple growth engines ahead

The Indian Pharmaceutical Market (IPM) is growing with increased consumer spend and awareness. Additionally, Indian pharmaceutical players with a large market share in IPM and a strong pipeline of speciality products will help them gain market share in the US and thereby partially offset any impact of competitive pricing pressure in the US. Moreover, other factors such as faster product approvals and resolutions by the USFDA regards to plant observations and 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, biosimilars, and injectables) and commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for Indian pharma companies.

■ Company Outlook – Earnings prospects weaken in short to medium term.

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 $4-6 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 with fall in revenue, however, could lead to margin pressures in the near term, though backward integration and expanded capacities could be the long-term levers.

■ Valuation – Downgrade to Hold with revised PT of Rs. 3,168

The company has been witnessing adverse products mix in favour of low-margin generic APIs (60% of revenue) while its high margin custom synthesis business (40% of revenue) has been falling y-o-y over the last two quarters after COVID 19 API opportunity tapers down. The company does not expect strong revenue growth to resume before FY2025-FY2026 with Contrast Media and Custom Synthesis business opportunities commercializing, which remain in the pipeline. With slower revenue growth and adverse products mix likely over short to medium term while few raw materials costs are expected to continue to trend higher, the profitability is not expected to resume back to historical levels, before FY2025-FY2026. At the same time, despite the recent correction in the stock price, the stock is trading at an expensive valuation of 35.0x/29.1x its FY24E/FY25E revised EPS estimates, respectively. Hence, we downgrade our Buy recommendation on it to Hold with a revised PT of Rs. 3,168.

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV/EBITDA (x)			RoE (%)		
				FY23	FY24E	FY25E	FY23	FY24E	FY25E	FY23	FY24E	FY25E
Laurus Labs	331.4	53.7	17,808	20.1	22.7	17.9	15.4	16.3	13.8	20.7	15.5	16.4
Divis Laboratories	2,884.4	26.5	76,570	39.2	35.0	29.1	25.5	21.4	17.7	14.9	15.0	15.8

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. With expanded capacities having been ready while new product opportunties are yet to fully commercialise fully untill FY2025, Divis business' prosepcts weaken over short – medium term.

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 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management	6.70
2	Life Insurance Corp India	5.53
3	Axis Asset Management	3.06
4	Government Pension Fund Global	1.20

Source: BSE

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

Disclaimer: This document has been prepared by Sharekhan Ltd. (SHAREKHAN) and is intended for use only by the person or entity to which it is addressed to. This Document may contain confidential and/or privileged material and is not for any type of circulation and any review, retransmission, or any other use is strictly prohibited. This Document is subject to changes without prior notice. This document does not constitute an offer to sell or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. Though disseminated to all customers who are due to receive the same, not all customers may receive this report at the same time. SHAREKHAN will not treat recipients as customers by virtue of their receiving this report.

The information contained herein is obtained from publicly available data or other sources believed to be reliable and SHAREKHAN has not independently verified the accuracy and completeness of the said data and hence it should not be relied upon as such. While we would endeavour to update the information herein on reasonable basis, SHAREKHAN, its subsidiaries and associated companies, their directors and employees ("SHAREKHAN and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance, or other reasons that may prevent SHAREKHAN and affiliates from doing so. This document is prepared for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. Recipients of this report should also be aware that past performance is not necessarily a guide to future performance and value of investments can go down as well. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved) and should consult its own advisors to determine the merits and risks of such an investment. The investment discussed or views expressed may not be suitable for all investors. We do not undertake to advise you as to any change of our views. Affiliates of Sharekhan may have issued other reports that are inconsistent with and reach different conclusions from the information presented in this report.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject SHAREKHAN and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

The analyst certifies that the analyst has not dealt or traded directly or indirectly in securities of the company and that all of the views expressed in this document accurately reflect his or her personal views about the subject company or companies and its or their securities and do not necessarily reflect those of SHAREKHAN. The analyst and SHAREKHAN further certifies that neither he or his relatives or Sharekhan associates has any direct or indirect financial interest nor have actual or beneficial ownership of 1% or more in the securities of the company at the end of the month immediately preceding the date of publication of the research report nor have any material conflict of interest nor has served as officer, director or employee or engaged in market making activity of the company. Further, the analyst has also not been a part of the team which has managed or co-managed the public offerings of the company and no part of the analyst's compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this document. Sharekhan Limited or its associates or analysts have not received any compensation for investment banking, merchant banking, brokerage services or any compensation or other benefits from the subject company or from third party in the past twelve months in connection with the research report.

Either, SHAREKHAN or its affiliates or its directors or employees / representatives / clients or their relatives may have position(s), make market, act as principal or engage in transactions of purchase or sell of securities, from time to time or may be materially interested in any of the securities or related securities referred to in this report and they may have used the information set forth herein before publication. SHAREKHAN may from time to time solicit from, or perform investment banking, or other services for, any company mentioned herein. Without limiting any of the foregoing, in no event shall SHAREKHAN, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind.

Compliance Officer: Ms. Binkle Oza; Tel: 022-61150000; email id: complianceofficer@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.