

REDUCE

TP: Rs 2,850 | ▲ 2%

DIVI'S LABS

Pharmaceuticals

08 August 2020

Q1 beat due to lumpiness – retain REDUCE on full valuations

Strong execution in Q1 drove a sharp 39% EBITDA beat for Divi's Labs (DIVI). Gross margin was stable QoQ at 62.8% but better operating leverage and currency benefits took EBITDA margin higher to 41% (35% est.). Generic API and CS sales mix were flat QoQ (sales up 20% YoY each in US\$ terms). Expect lumpiness ahead on a high Q1 base. Strong API growth was backed by a rising preference for Indian suppliers vs. China. We raise FY21-FY22 EPS 10% and move to a new TP of Rs 2,850 (vs. Rs 2,350), set at 25x Sep'22E EV/EBITDA.

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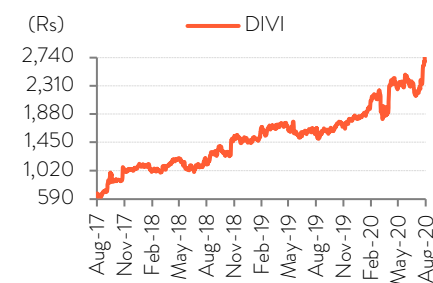
Strong sales and margin beat due to lumpiness: We believe some spillover sales from Q4 and China supply de-risking led to the strong Q1 sales (+24% QoQ). In US dollar terms, CS business grew 20% QoQ (revenue share flat at 41%) and generic APIs also grew 20% QoQ. Sequential EBITDA margin recovery to 41% (32.6% in Q4) stemmed from (1) an opex decline of 10% QoQ (SGA: – 22% QoQ on a high base), and (2) currency benefits of 2ppt assuming 50% of INR benefit was passed on. Management has advised not to extrapolate Q1 numbers given lumpiness in the business. We reset our margin assumptions on higher operating leverage, driving our 10% EPS upgrades for FY21 and FY22.

Earnings call highlights: (1) It is difficult for developed countries to start a new API plant and compete with the existing generics on cost structure. (2) Q1 had a Rs 54mn forex gain. (3) Brownfield expansion for Unit 1/ 2 could be completed by FY21-end – a portion of the capex also focused on backward integration for some molecules where DIVI has leadership, such as Naproxen or Gabapentin. (4) Q1 capitalisation stood at Rs 2.2bn.

Stock fully valued: While DIVI's execution track record is impressive, we believe the stock could underperform in the midterm given stretched valuations – it is trading at 35x FY22E EPS vs. the historical 3Y band of 20-35x.

| | |
|------------------|-------------------|
| Ticker/Price | DIVI IN/Rs 2,785 |
| Market cap | US\$ 9.9bn |
| Shares o/s | 266mn |
| 3M ADV | US\$ 32.3mn |
| 52wk high/low | Rs 2,820/Rs 1,466 |
| Promoter/FPI/DII | 52%/18%/17% |

Source: NSE

STOCK PERFORMANCE

Source: NSE

KEY FINANCIALS

| Y/E 31 Mar | FY19A | FY20P | FY21E | FY22E | FY23E |
|-------------------------|--------|--------|--------|--------|--------|
| Total revenue (Rs mn) | 49,462 | 54,088 | 65,984 | 77,849 | 90,598 |
| EBITDA (Rs mn) | 18,719 | 18,150 | 24,781 | 30,639 | 37,287 |
| Adj. net profit (Rs mn) | 13,219 | 12,903 | 17,108 | 21,427 | 26,382 |
| Adj. EPS (Rs) | 49.8 | 48.6 | 64.4 | 80.7 | 99.4 |
| Adj. EPS growth (%) | 55.8 | (2.4) | 32.6 | 25.2 | 23.1 |
| Adj. ROAE (%) | 20.6 | 18.2 | 21.7 | 23.3 | 24.6 |
| Adj. P/E (x) | 55.9 | 57.3 | 43.2 | 34.5 | 28.0 |
| EV/EBITDA (x) | 38.5 | 39.7 | 29.2 | 23.8 | 19.5 |

Source: Company, BOBCAPS Research

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Important disclosures, including any required research certifications, are provided at the end of this report.



FIG 1 – QUARTERLY PERFORMANCE

| (Rs mn) | Q1FY21 | Q1FY20 | YoY (%) | Q4FY20 | QoQ (%) | Q1FY21E | Var (%) | FY20 | FY19 | YoY (%) |
|-------------------------|---------------|---------------|-------------|---------------|-------------|---------------|-------------|---------------|---------------|--------------|
| Net Sales | 17,099 | 11,399 | 50.0 | 13,762 | 24.2 | 14,400 | 18.7 | 53,104 | 48,796 | 8.8 |
| EBITDA | 6,988 | 3,846 | 81.7 | 4,486 | 55.8 | 5,029 | 39.0 | 18,155 | 18,487 | (1.8) |
| Depreciation | 559 | 438 | - | 495 | - | 545 | - | 1,859 | 1,693 | - |
| EBIT | 6,429 | 3,408 | 88.7 | 3,991 | 61.1 | 4,484 | - | 16,296 | 16,794 | (3.0) |
| Interest | 2 | 3 | - | 4 | - | 10 | - | 61 | 35 | - |
| Other Income | 126 | 316 | - | 194 | - | 200 | - | 1,079 | 1,255 | - |
| PBT | 6,553 | 3,721 | 76.1 | 4,181 | 56.7 | 4,674 | - | 17,314 | 18,014 | (3.9) |
| Less: Taxation | 1,684 | 988 | - | 834 | - | 1,169 | 515 | 4,406 | 5,005 | - |
| Less: Minority Interest | 0 | 0 | - | 0 | - | 0 | - | 0 | 0 | - |
| Recurring PAT | 4,869 | 2,733 | 78.1 | 3,347 | 45.5 | 3,506 | 38.9 | 12,908 | 13,009 | (0.8) |
| Exceptional items | 54 | (60) | - | 571 | - | 0 | - | 819 | 315 | - |
| Reported PAT | 4,922 | 2,673 | 84.1 | 3,918 | 25.6 | 3,506 | 40.4 | 13,728 | 13,324 | 3.0 |
| Key Ratios (%) | | | | | | | | | | |
| Gross Margin | 62.8 | 60.2 | - | 62.9 | - | 61.5 | - | 60.7 | 62.3 | - |
| EBITDA Margin | 40.9 | 33.7 | - | 32.6 | - | 34.9 | - | 34.2 | 37.9 | - |
| Tax / PBT | 25.7 | 26.5 | - | 19.9 | - | 25.0 | - | 25.4 | 27.8 | - |
| NPM | 28.5 | 24.0 | - | 24.3 | - | 24.3 | - | 24.3 | 26.7 | - |
| EPS (Rs) | 18.3 | 10.3 | - | 12.6 | - | 13.2 | - | 48.6 | 49.0 | - |

Source: Company, BOBCAPS Research

Valuation methodology

We continue to like DIVI’s solid execution (across chemistry skills), cost edge, strong balance sheet and robust cash flows. But valuations are expensive, with the stock trading at 35x FY22E earnings vs. the three-year historical P/E band of 20-35x for earnings growth of 26% over the next two years. We raise our FY21/FY22 EPS estimates by 10% each to Rs 64/Rs 81, factoring in higher EBITDA margins and early improvement in operating leverage on the new capex.

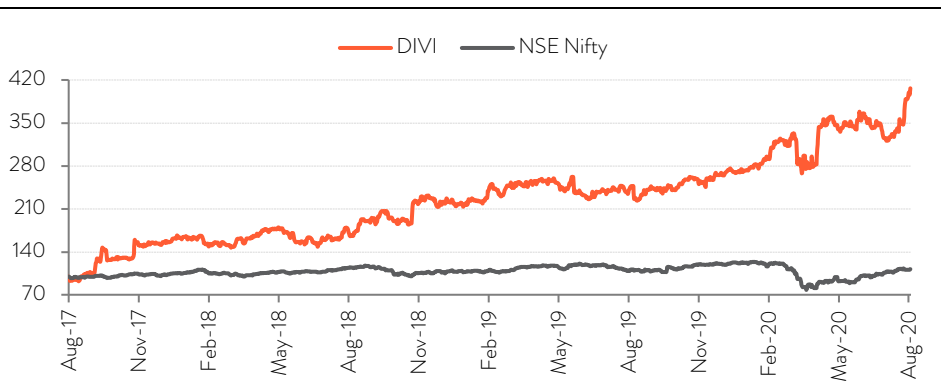
Retain REDUCE with a revised Sep’21 target price of Rs 2,850 (from Rs 2,350) as we roll over to a Sep’22E EV/EBITDA multiple of 25x (vs. 22x earlier), which represents an implied P/E of 33x. The increase in target multiple is in line with broader sectoral multiple expansion.

FIG 2 – REVISED ESTIMATES

| (Rs bn) | New | | Old | | Change (%) | |
|-------------------|-------|-------|-------|-------|------------|--------|
| | FY21E | FY22E | FY21E | FY22E | FY21E | FY22E |
| Sales | 66 | 78 | 62 | 73 | 7.1 | 7.0 |
| EBITDA | 25 | 31 | 23 | 28 | 10.1 | 9.8 |
| EBITDA margin (%) | 37.6 | 39.4 | 36.6 | 38.4 | 100bps | 100bps |
| EPS (Rs) | 64 | 81 | 58 | 73 | 11.0 | 10.3 |

Source: Company, BOBCAPS Research

FIG 3 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- **Facility concentration risk:** Vizag Unit II continues to account for 60% of revenues, of which ~37% are sales to the US and 33% are EU sales. Any adverse regulatory actions by the USFDA will pose a significant risk to earnings.
- **Currency risk:** DIVI has net forex exposure of 65% of sales which is unhedged. Usually 50-60% of the currency volatility is a pass-through to customers. Our calculations suggest that a 5% movement in the USDINR rate will have a ~5% impact on operating profits (assuming 50% is passed on).
- **Disclosure-related risk:** Limited product-related disclosure due to confidentiality terms is another key risk.

FINANCIALS

Income Statement

| Y/E 31 Mar (Rs mn) | FY19A | FY20P | FY21E | FY22E | FY23E |
|--------------------------------|---------------|---------------|---------------|---------------|---------------|
| Total revenue | 49,462 | 54,088 | 65,984 | 77,849 | 90,598 |
| EBITDA | 18,719 | 18,150 | 24,781 | 30,639 | 37,287 |
| Depreciation | 1,689 | 1,859 | 2,603 | 2,694 | 2,856 |
| EBIT | 17,030 | 16,291 | 22,178 | 27,945 | 34,431 |
| Net interest income/(expenses) | (35) | (61) | 0 | 0 | 0 |
| Other income/(expenses) | 1,247 | 1,079 | 632 | 624 | 745 |
| Exceptional items | 0 | 0 | 0 | 0 | 0 |
| EBT | 18,242 | 17,309 | 22,810 | 28,569 | 35,176 |
| Income taxes | 5,023 | 4,406 | 5,703 | 7,142 | 8,794 |
| Extraordinary items | 309 | 819 | 0 | 0 | 0 |
| Min. int./Inc. from associates | 0 | 0 | 0 | 0 | 0 |
| Reported net profit | 13,528 | 13,723 | 17,108 | 21,427 | 26,382 |
| Adjustments | (309) | (819) | 0 | 0 | 0 |
| Adjusted net profit | 13,219 | 12,903 | 17,108 | 21,427 | 26,382 |

Balance Sheet

| Y/E 31 Mar (Rs mn) | FY19A | FY20P | FY21E | FY22E | FY23E |
|---------------------------------------|---------------|---------------|---------------|----------------|----------------|
| Accounts payables | 4,922 | 5,789 | 6,031 | 6,917 | 7,820 |
| Other current liabilities | 4,797 | 5,730 | 5,730 | 5,730 | 5,730 |
| Provisions | 143 | 451 | 0 | 0 | 0 |
| Debt funds | 1,056 | 336 | 0 | 0 | 0 |
| Other liabilities | 0 | 0 | 0 | 0 | 0 |
| Equity capital | 531 | 531 | 531 | 531 | 531 |
| Reserves & surplus | 68,932 | 71,520 | 84,781 | 98,230 | 114,790 |
| Shareholders' fund | 69,463 | 72,051 | 85,312 | 98,761 | 115,321 |
| Total liabilities and equities | 80,381 | 84,357 | 97,072 | 111,409 | 128,871 |
| Cash and cash eq. | 1,152 | 1,225 | 1,020 | 4,045 | 9,859 |
| Accounts receivables | 11,633 | 14,133 | 15,717 | 18,543 | 21,579 |
| Inventories | 17,723 | 18,638 | 21,693 | 25,594 | 29,786 |
| Other current assets | 4,698 | 3,750 | 3,358 | 3,358 | 3,358 |
| Investments | 19,455 | 9,713 | 9,713 | 9,713 | 9,713 |
| Net fixed assets | 20,761 | 27,662 | 32,059 | 32,365 | 32,510 |
| CWIP | 4,919 | 9,196 | 13,473 | 17,750 | 22,027 |
| Intangible assets | 40 | 40 | 40 | 40 | 40 |
| Deferred tax assets, net | 0 | 0 | 0 | 0 | 0 |
| Other assets | 0 | 0 | 0 | 0 | 0 |
| Total assets | 80,381 | 84,357 | 97,072 | 111,409 | 128,871 |

Source: Company, BOBCAPS Research

Cash Flows

| Y/E 31 Mar (Rs mn) | FY19A | FY20P | FY21E | FY22E | FY23E |
|-------------------------------------|----------------|-----------------|-----------------|----------------|----------------|
| Net income + Depreciation | 15,217 | 15,582 | 19,711 | 24,120 | 29,238 |
| Interest expenses | 35 | 61 | 0 | 0 | 0 |
| Non-cash adjustments | 0 | 0 | 0 | 0 | 0 |
| Changes in working capital | (5,808) | (907) | (4,456) | (5,840) | (6,325) |
| Other operating cash flows | 0 | 0 | 0 | 0 | 0 |
| Cash flow from operations | 9,443 | 14,735 | 15,254 | 18,280 | 22,912 |
| Capital expenditures | (6,307) | (13,037) | (11,277) | (7,277) | (7,277) |
| Change in investments | (563) | 9,742 | 0 | 0 | 0 |
| Other investing cash flows | 0 | 0 | 0 | 0 | 0 |
| Cash flow from investing | (6,870) | (3,295) | (11,277) | (7,277) | (7,277) |
| Equities issued/Others | 0 | 0 | 0 | 0 | 0 |
| Debt raised/repaid | 425 | (720) | (336) | 0 | 0 |
| Interest expenses | (35) | (61) | 0 | 0 | 0 |
| Dividends paid | 0 | 0 | 0 | 0 | 0 |
| Other financing cash flows | (2,936) | (10,587) | (3,846) | (7,977) | (9,822) |
| Cash flow from financing | (2,546) | (11,368) | (4,182) | (7,977) | (9,822) |
| Changes in cash and cash eq. | 28 | 73 | (205) | 3,026 | 5,813 |
| Closing cash and cash eq. | 1,152 | 1,225 | 1,020 | 4,045 | 9,859 |

Per Share

| Y/E 31 Mar (Rs) | FY19A | FY20P | FY21E | FY22E | FY23E |
|----------------------|-------|-------|-------|-------|-------|
| Reported EPS | 51.0 | 51.7 | 64.4 | 80.7 | 99.4 |
| Adjusted EPS | 49.8 | 48.6 | 64.4 | 80.7 | 99.4 |
| Dividend per share | 19.0 | 19.2 | 24.0 | 30.0 | 37.0 |
| Book value per share | 261.6 | 271.4 | 321.3 | 372.0 | 434.4 |

Valuations Ratios

| Y/E 31 Mar (x) | FY19A | FY20P | FY21E | FY22E | FY23E |
|----------------|-------|-------|-------|-------|-------|
| EV/Sales | 14.6 | 13.3 | 11.0 | 9.4 | 8.0 |
| EV/EBITDA | 38.5 | 39.7 | 29.2 | 23.8 | 19.5 |
| Adjusted P/E | 55.9 | 57.3 | 43.2 | 34.5 | 28.0 |
| P/BV | 10.6 | 10.3 | 8.7 | 7.5 | 6.4 |

DuPont Analysis

| Y/E 31 Mar (%) | FY19A | FY20P | FY21E | FY22E | FY23E |
|---------------------------------|-------|-------|-------|-------|-------|
| Tax burden (Net profit/PBT) | 72.5 | 74.5 | 75.0 | 75.0 | 75.0 |
| Interest burden (PBT/EBIT) | 107.1 | 106.2 | 102.8 | 102.2 | 102.2 |
| EBIT margin (EBIT/Revenue) | 34.4 | 30.1 | 33.6 | 35.9 | 38.0 |
| Asset turnover (Revenue/Avg TA) | 16.7 | 16.4 | 18.2 | 18.7 | 18.9 |
| Leverage (Avg TA/Avg Equity) | 1.2 | 1.2 | 1.2 | 1.1 | 1.1 |
| Adjusted ROAE | 20.6 | 18.2 | 21.7 | 23.3 | 24.6 |

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

| Y/E 31 Mar | FY19A | FY20P | FY21E | FY22E | FY23E |
|--|-------|-------|-------|-------|-------|
| YoY growth (%) | | | | | |
| Revenue | 27.1 | 9.4 | 22.0 | 18.0 | 16.4 |
| EBITDA | 48.5 | (3.0) | 36.5 | 23.6 | 21.7 |
| Adjusted EPS | 55.8 | (2.4) | 32.6 | 25.2 | 23.1 |
| Profitability & Return ratios (%) | | | | | |
| EBITDA margin | 37.8 | 33.6 | 37.6 | 39.4 | 41.2 |
| EBIT margin | 34.4 | 30.1 | 33.6 | 35.9 | 38.0 |
| Adjusted profit margin | 26.7 | 23.9 | 25.9 | 27.5 | 29.1 |
| Adjusted ROAE | 20.6 | 18.2 | 21.7 | 23.3 | 24.6 |
| ROCE | 19.7 | 17.5 | 20.9 | 22.6 | 24.0 |
| Working capital days (days) | | | | | |
| Receivables | 80 | 87 | 87 | 87 | 87 |
| Inventory | 115 | 123 | 120 | 120 | 120 |
| Payables | 90 | 93 | 93 | 93 | 93 |
| Ratios (x) | | | | | |
| Gross asset turnover | 1.5 | 1.3 | 1.4 | 1.5 | 1.7 |
| Current ratio | 3.6 | 3.2 | 3.6 | 4.1 | 4.8 |
| Net interest coverage ratio | 486.6 | 268.8 | | | |
| Adjusted debt/equity | (0.3) | (0.1) | (0.1) | (0.1) | (0.2) |

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

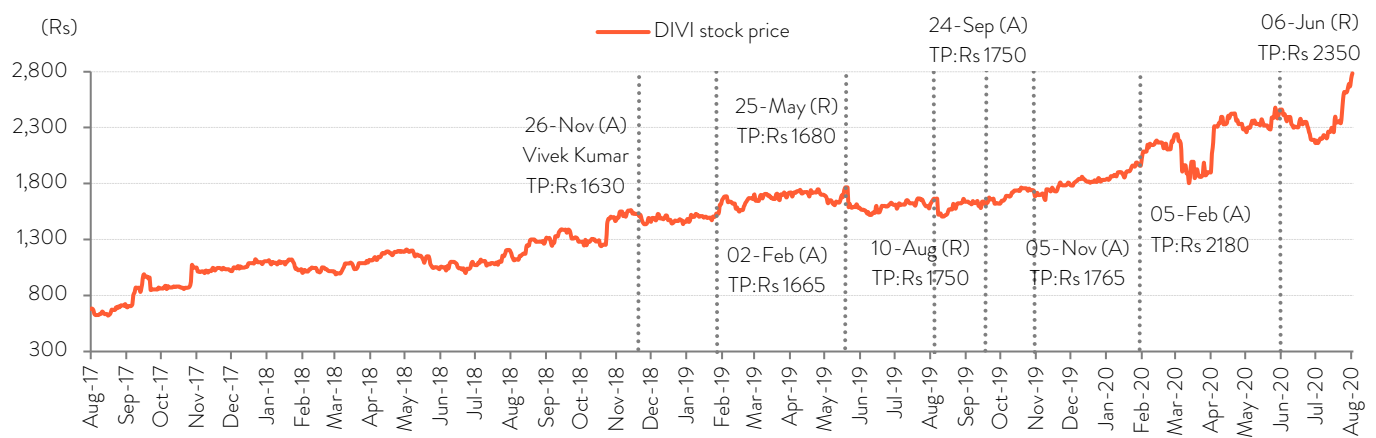
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

RATINGS AND TARGET PRICE (3-YEAR HISTORY): DIVI'S LABS (DIVI IN)



B – Buy, A – Add, R – Reduce, S – Sell

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