

ADD

TP: Rs 1,765 | ▲ 5%

DIVI'S LABS

Pharmaceuticals

05 November 2019

Good Q2 beat; FY20 margin guidance cut is negative

Overall Revenue/EBITDA were 13% ahead of our estimates but largely in-line with consensus. Key negative in Q2 were (1) subdued gross margins 58.9% which is 13-quarters low as CS mix were flat at 41% & high cost Chinese RM and (2) FY20 margin guidance cut to 34-36%. DIVI expects margin normalcy to be delayed and sales run-rate for next two quarter to stay at Q2 range. Cut FY20 EPS by 3%. Maintain ADD with revise TP of Rs 1,765 (earlier Rs 1,750). Upside in stock should remain capped, in our view.

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FY20 margin guidance lowered: Divi's has lowered its EBITDA margins guidance for FY20 to 34-36% (from 37-38%), following 1H margin of 34.2% and higher material prices in generic segment. This has impacted our FY20 EPS by 3% however FY21/22 is unchanged. Q2 gross margins were down 132bps at 58.9% on weak product mix – CS business grew 9% YoY with Sales mix at 41%, flat QoQ and new customer addition in generic APIs leading to high cost inventory procurement to ensure consistency of supplies. Backward integration of several APIs is progressing well, but the flow through benefit could take some more time (likely Q4).

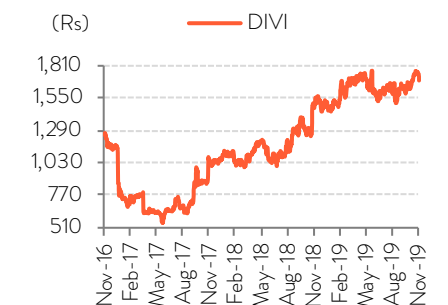
Call highlights: (1) Divi's had to stock up for more inventories as several other customers are asking for volumes. (2) Q2 forex gains was Rs 129mn. (3) Implementation of total capex of Rs 16.9bn is on track. (4) Q2/1H capitalisation was Rs 920mn/2.1bn – expected total capitalisation is at Rs 12bn in FY20 incl. CWIP. (5) Nutraceutical Sales were up 140% YoY to Rs 2.6bn.

Retain ADD but upside capped: At 26x FY21 P/E, we believe stock is largely pricing in growth recovery in FY21 (expect 23% growth). Our EPS for FY20 is cut to Rs52 (1H was Rs23) and FY21 is Rs 64 (unchanged). Stock has traded at 3Y/5Y historical mean of 24-25x.

Ticker/Price	DIVI IN/Rs 1,687
Market cap	US\$ 6.3bn
Shares o/s	266mn
3M ADV	US\$ 12.5mn
52wk high/low	Rs 1,779/Rs 1,420
Promoter/FPI/DII	52%/17%/17%

Source: NSE

STOCK PERFORMANCE



KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	38,906	49,462	54,713	63,852	74,121
EBITDA (Rs mn)	12,608	18,719	19,828	24,545	29,975
Adj. net profit (Rs mn)	8,482	13,219	13,902	17,104	20,988
Adj. EPS (Rs)	31.9	49.8	52.4	64.4	79.1
Adj. EPS growth (%)	(22.9)	55.8	5.2	23.0	22.7
Adj. ROAE (%)	15.0	20.6	19.3	21.4	22.8
Adj. P/E (x)	52.8	33.9	32.2	26.2	21.3
EV/EBITDA (x)	34.2	22.9	21.6	17.3	14.1

Source: Company, BOBCAPS Research

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FIG 1 – QUARTERLY PERFORMANCE

(Rs mn)	Q2FY20	Q2FY19	YoY (%)	Q1FY20	QoQ (%)	Q2FY20E	Var (%)
Net Sales	14,039	12,850	9.3	11,399	23.2	12,425	13.0
EBITDA	4,854	5,142	(5.6)	3,846	26.2	4,280	13.4
Depreciation	459	429	-	438	-	438	-
EBIT	4,395	4,713	(6.7)	3,408	29.0	3,842	-
Interest	38	2	-	3	-	5	-
Other Income	345	270	-	316	-	316	-
PBT	4,702	4,981	(5.6)	3,721	26.4	4,153	-
Less: Taxation	1,302	1,539	-	988	-	1,163	-
Less: Minority Interest	0	0	-	0	-	0	-
Recurring PAT	3,400	3,442	(1.2)	2,733	24.4	2,990	13.7
Exceptional items	129	530	-	(60)	-	0	-
Reported PAT	3,529	3,972	(11.2)	2,673	32.0	2,990	18.0
Key Ratios (%)							
Gross Margin	58.9	63.2	-	60.2	-	61.0	-
EBITDA Margin	34.6	40.0	-	33.7	-	34.4	-
Tax / PBT	27.7	30.9	-	26.5	-	28.0	-
NPM	24.2	26.8	-	24.0	-	24.1	-
EPS (Rs)	12.8	13.0	-	10.3	-	11.3	-

Source: Company, BOBCAPS Research

Valuation methodology

While we continue to like DIVI's solid execution, we believe medium term margin trajectory will remain subdued. Also, expectations of better earnings growth for FY21/22 of 23%+ is partly reflected in the current price hence we expect stock to remain in the range bound.

Management has lowered its margin guidance for FY20 driving ~3% EPS cut. This is mainly due to higher generic API mix and higher raw material prices from China which should stabilise towards end of 4QFY20 with some benefit of back ward integration. We maintain our FY21/FY22 EPS estimates of Rs 64/79 and revised our price target to Rs 1,765 (from Rs 1,750).

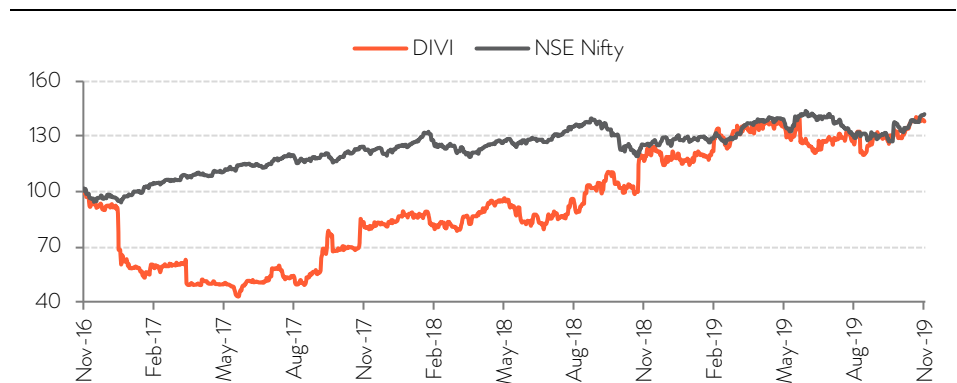
Retain ADD on reasonable valuations – the stock is trading at 26x FY21E earnings vs. the three-year/five-year historical mean of 24-25x.

FIG 2 – REVISED ESTIMATES

(Rs mn)	New			Old			Change (%)		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Sales	54.7	63.9	74.1	54.1	63.2	74.1	1.1	1.0	0.0
EBITDA	19.8	24.5	30.0	20.4	24.6	30.0	(2.9)	(0.3)	0.0
EBITDA margin (%)	36.2	38.4	40.4	37.7	38.9	40.4	(150bps)	(50bps)	0bps
EPS (Rs)	52	64	79	54	65	79.05	(3.0)	(0.4)	0.0

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)	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue	38,906	49,462	54,713	63,852	74,121
EBITDA	12,608	18,719	19,828	24,545	29,975
Depreciation	1,424	1,689	1,822	2,298	2,410
EBIT	11,184	17,030	18,006	22,247	27,565
Net interest income/(expenses)	(13)	(35)	(35)	(17)	(17)
Other income/(expenses)	855	1,247	1,213	1,373	1,414
Exceptional items	0	0	0	0	0
EBT	12,025	18,242	19,185	23,603	28,963
Income taxes	3,543	5,023	5,283	6,499	7,975
Extraordinary items	280	309	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	8,762	13,528	13,902	17,104	20,988
Adjustments	(280)	(309)	0	0	0
Adjusted net profit	8,482	13,219	13,902	17,104	20,988

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	4,112	4,922	5,132	5,562	6,090
Other current liabilities	3,679	4,767	4,767	4,767	4,767
Provisions	158	143	0	0	0
Debt funds	631	1,056	1,056	500	500
Other liabilities	0	0	0	0	0
Equity capital	531	531	531	531	531
Reserves & surplus	58,639	68,943	74,176	84,925	98,115
Shareholders' fund	59,170	69,474	74,707	85,456	98,646
Total liabilities and equities	67,750	80,362	85,662	96,285	110,003
Cash and cash eq.	1,124	1,152	5,149	6,174	13,798
Accounts receivables	10,143	11,633	12,044	14,056	16,316
Inventories	13,506	17,723	17,272	20,157	23,399
Other current assets	2,983	4,698	4,344	4,344	4,344
Investments	18,892	19,455	19,455	19,455	19,455
Net fixed assets	19,873	20,761	22,439	27,141	27,732
CWIP	1,197	4,919	4,919	4,919	4,919
Intangible assets	33	40	40	40	40
Deferred tax assets, net	0	0	0	0	0
Other assets	0	0	0	0	0
Total assets	67,750	80,381	85,662	96,285	110,003

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	10,186	15,217	15,724	19,402	23,398
Interest expenses	13	35	35	17	17
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(2,508)	(5,838)	462	(4,466)	(4,975)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	7,692	9,413	16,220	14,953	18,439
Capital expenditures	(2,500)	(6,307)	(3,500)	(7,000)	(3,000)
Change in investments	(2,585)	(563)	0	0	0
Other investing cash flows	0	0	0	0	0
Cash flow from investing	(5,085)	(6,870)	(3,500)	(7,000)	(3,000)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	274	425	0	(556)	0
Interest expenses	(13)	(35)	(35)	(17)	(17)
Dividends paid	0	0	0	0	0
Other financing cash flows	(2,530)	(2,926)	(8,669)	(6,355)	(7,798)
Cash flow from financing	(2,269)	(2,536)	(8,704)	(6,928)	(7,815)
Changes in cash and cash eq.	338	8	4,016	1,025	7,625
Closing cash and cash eq.	1,124	1,132	5,149	6,174	13,798

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	33.0	51.0	52.4	64.4	79.1
Adjusted EPS	31.9	49.8	52.4	64.4	79.1
Dividend per share	12.0	18.9	19.5	23.9	29.4
Book value per share	222.9	261.7	281.4	321.9	371.5

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	11.1	8.7	7.8	6.6	5.7
EV/EBITDA	34.2	22.9	21.6	17.3	14.1
Adjusted P/E	52.8	33.9	32.2	26.2	21.3
P/BV	7.6	6.4	6.0	5.2	4.5

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	70.5	72.5	72.5	72.5	72.5
Interest burden (PBT/EBIT)	107.5	107.1	106.5	106.1	105.1
EBIT margin (EBIT/Revenue)	28.7	34.4	32.9	34.8	37.2
Asset turnover (Revenue/Avg TA)	15.0	16.7	16.5	17.5	18.0
Leverage (Avg TA/Avg Equity)	1.1	1.2	1.2	1.1	1.1
Adjusted ROAE	15.0	20.6	19.3	21.4	22.8

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

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	(4.3)	27.1	10.6	16.7	16.1
EBITDA	(15.1)	48.5	5.9	23.8	22.1
Adjusted EPS	(22.9)	55.8	5.2	23.0	22.7
Profitability & Return ratios (%)					
EBITDA margin	32.4	37.8	36.2	38.4	40.4
EBIT margin	28.7	34.4	32.9	34.8	37.2
Adjusted profit margin	21.8	26.7	25.4	26.8	28.3
Adjusted ROAE	15.0	20.6	19.3	21.4	22.8
ROCE	14.5	19.7	18.5	20.6	22.2
Working capital days (days)					
Receivables	90	80	80	80	80
Inventory	125	115	115	115	115
Payables	95	90	90	90	90
Ratios (x)					
Gross asset turnover	1.3	1.5	1.5	1.5	1.6
Current ratio	3.5	3.6	3.9	4.3	5.3
Net interest coverage ratio	840.9	486.6	514.5	1,342.4	1,663.4
Adjusted debt/equity	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

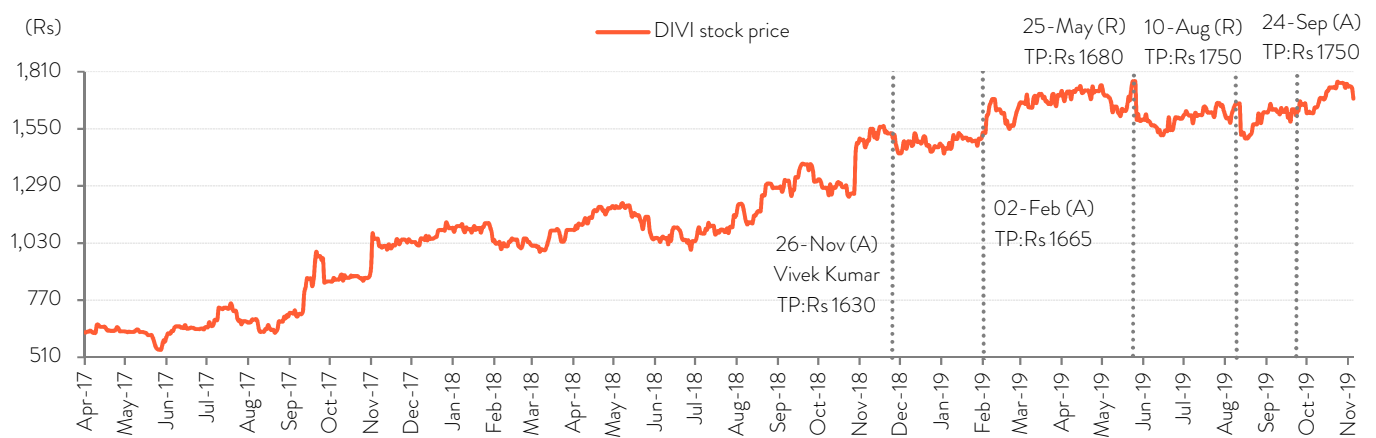
ADD – Expected return from >+5% to +15%

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)

HISTORICAL RATINGS AND TARGET PRICE: DIVI'S LABS (DIVI IN)



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

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