

ADD

TP: Rs 3,520 | ▲ 9%

DIVI'S LABS

Pharmaceuticals

07 November 2020

Flawless execution drives Q2 beat – upgrade to ADD

Divi's Labs (DIVI) retained its strong execution in Q2, reporting an 18% EBITDA beat. Gross/EBITDA margins of 67%/43% hit multi-year highs, rising 420bps/260bps QoQ on better operating leverage and backward integration benefits. Generic API and CS sales mix was flat QoQ. DIVI is cautiously optimistic on H1 sales and margins but conservatively expects to sustain >60% gross margin. Fresh capex in CS is backed by strong order visibility. We raise FY21-FY23 EPS 3-9% and our Sep'21 TP to Rs 3,520 (vs. Rs 2,850). Upgrade to ADD (vs. REDUCE).

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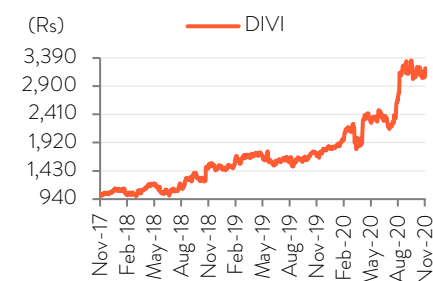
Strong sales and multi-year high margins: Robust execution coupled with China supply derisking led to strong Q2 sales (+22% YoY), but margins were a bigger surprise. EBITDA margin scaled new highs QoQ to 43.5% (41% in Q1 and 34% in FY20), led mainly by gross margin expansion to 67% from 63% (backward integration benefit). Management has advised not to extrapolate Q2 given lumpiness in the business. In dollar terms, CS business grew 13% YoY (40% of the mix) and generic APIs 18% YoY. DIVI's order book has risen and operating leverage has improved; we raise FY21-FY23 EPS by 3-9%.

Ticker/Price	DIVI IN/Rs 3,237
Market cap	US\$ 11.6bn
Shares o/s	266mn
3M ADV	US\$ 59.3mn
52wk high/low	Rs 3,389/Rs 1,626
Promoter/FPI/DII	52%/18%/17%

Source: NSE

Capex on fast track and other takeaways: (1) Commercial benefit of new capex worth Rs 4bn in CS segment to start Jul/Aug'21. (2) Brownfield expansion for Unit 1/2 could be completed by FY21-end – all integration projects related to leadership molecules Naproxen and Gabapentin completed in Q2. (3) Kakinada site work to start from Dec'20 – ROI to take three years. (4) Q2 capitalisation stood at Rs 6.2bn (H1: Rs 8.3bn). (5) Q2 had Rs 123mn forex loss.

STOCK PERFORMANCE



Upgrade to ADD: DIVI has the best execution record in the CDMO space. With Big Pharma outsourcing gaining momentum and a strong cost edge, its valuation premium can sustain. The stock is at 22x FY23E EBITDA (vs. 3Y band of 13-27x). We raise our TP to Rs 3,520 (set at 26x EV/EBITDA vs. 25x earlier).

KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	49,462	54,088	67,089	79,175	92,122
EBITDA (Rs mn)	18,719	18,150	26,901	31,747	38,321
Adj. net profit (Rs mn)	13,219	12,903	18,697	22,269	27,187
Adj. EPS (Rs)	49.8	48.6	70.4	83.9	102.4
Adj. EPS growth (%)	55.8	(2.4)	44.9	19.1	22.1
Adj. ROAE (%)	20.6	18.2	23.6	23.9	25.0
Adj. P/E (x)	65.0	66.6	46.0	38.6	31.6
EV/EBITDA (x)	45.0	46.3	31.4	26.7	22.1

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)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)	Q2FY21E	Var (%)	H1FY21	H1FY20	YoY (%)
Net Sales	17,137	14,039	22.1	17,099	0.2	16,285	5.2	34,236	25,438	34.6
EBITDA	7,446	4,854	53.4	6,988	6.6	6,290	18.4	14,434	8,700	65.9
Depreciation	609	459	-	559	-	587	-	1,168	897	-
EBIT	6,837	4,395	55.6	6,429	6.3	5,703	-	13,266	7,803	70.0
Interest	1	38	-	2	-	2	-	3	41	-
Other Income	136	345	-	126	-	126	-	262	661	-
PBT	6,972	4,702	48.3	6,553	6.4	5,827	-	13,525	8,422	60.6
Less: Taxation	1,717	1,302	-	1,684	-	1,457	261	3,401	2,290	-
Less: Minority Interest	0	0	-	0	-	0	-	0	0	-
Recurring PAT	5,255	3,400	54.6	4,869	7.9	4,370	20.2	10,124	6,133	65.1
Exceptional items	(123)	129	-	54	-	0	-	(69)	69	-
Reported PAT	5,132	3,529	45.4	4,922	4.3	4,370	17.4	10,055	6,202	62.1
Key Ratios (%)										
Gross Margin	67.0	58.9	-	62.8	-	63.0	-	64.9	59.5	-
EBITDA Margin	43.5	34.6	-	40.9	-	38.6	-	42.2	34.2	-
Tax / PBT	24.6	27.7	-	25.7	-	25.0	-	25.1	27.2	-
NPM	30.7	24.2	-	28.5	-	26.8	-	29.6	24.1	-
EPS (Rs)	19.8	12.8	-	18.3	-	16.5	-	38.1	23.1	-

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. We expect earnings growth of 30% over the next three years (FY20-FY23). The stock is trading at 32x FY23E earnings vs. the three-year historical P/E band of 20-40x. On EV/EBITDA, the stock is at 22x FY23E vs. the three-year band of 13-27x.

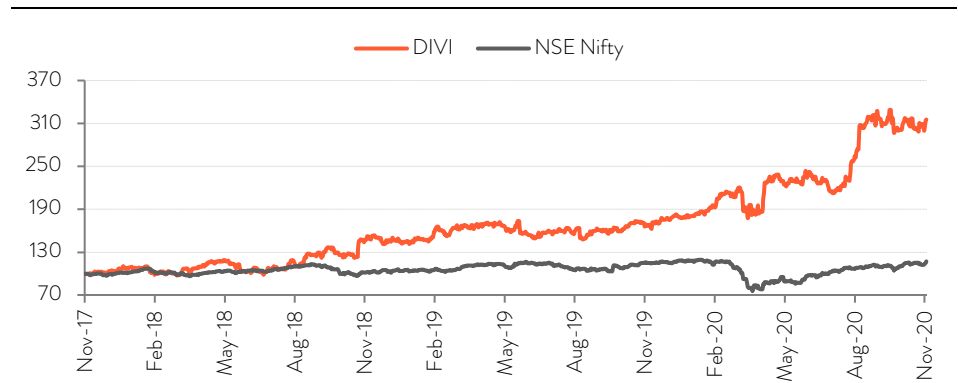
We raise our FY21/FY22/FY23 EPS estimates by 9%/4%/3% to Rs 70/Rs 84/Rs 102, factoring in higher EBITDA margins and early improvement in operating leverage on the new capex. We also upgrade the stock to ADD from REDUCE and raise our Sep’21 target price to Rs 3,520 (from Rs 2,850), based on an EV/EBITDA multiple of 26x (25x earlier) and implied P/E of 38x.

FIG 2 – REVISED ESTIMATES

(Rs bn)	New			Old			Change (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Sales	67.1	79.2	92.1	66.0	77.8	90.6	1.7	1.7	1.7
EBITDA	26.9	31.7	38.3	24.8	30.6	37.3	8.6	3.6	2.8
EBITDA margin (%)	40.1	40.1	41.6	37.6	39.4	41.2	254bps	74bps	44bps
EPS (Rs)	70	84	102	64	81	99.4	9.3	3.9	3.1

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	FY20A	FY21E	FY22E	FY23E
Total revenue	49,462	54,088	67,089	79,175	92,122
EBITDA	18,719	18,150	26,901	31,747	38,321
Depreciation	1,689	1,859	2,603	2,694	2,856
EBIT	17,030	16,291	24,298	29,054	35,465
Net interest income/(expenses)	(35)	(61)	0	0	0
Other income/(expenses)	1,247	1,079	632	639	784
Exceptional items	0	0	0	0	0
EBT	18,242	17,309	24,930	29,693	36,249
Income taxes	5,023	4,406	6,232	7,423	9,062
Extraordinary items	309	819	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	13,528	13,723	18,697	22,269	27,187
Adjustments	(309)	(819)	0	0	0
Adjusted net profit	13,219	12,903	18,697	22,269	27,187

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	4,922	5,789	6,046	7,136	8,186
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	85,779	99,757	116,822
Shareholders' fund	69,463	72,051	86,310	100,288	117,353
Total liabilities and equities	80,381	84,357	98,086	113,154	131,269
Cash and cash eq.	1,152	1,225	1,407	5,039	11,392
Accounts receivables	11,633	14,133	15,980	18,858	21,942
Inventories	17,723	18,638	22,057	26,030	30,287
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	98,086	113,154	131,269

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	15,217	15,582	21,300	24,963	30,043
Interest expenses	35	61	0	0	0
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(5,808)	(907)	(5,067)	(5,763)	(6,291)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	9,443	14,735	16,233	19,200	23,752
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)	(4,438)	(8,291)	(10,122)
Cash flow from financing	(2,546)	(11,368)	(4,774)	(8,291)	(10,122)
Changes in cash and cash eq.	28	73	182	3,632	6,353
Closing cash and cash eq.	1,152	1,225	1,407	5,039	11,392

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	51.0	51.7	70.4	83.9	102.4
Adjusted EPS	49.8	48.6	70.4	83.9	102.4
Dividend per share	19.0	19.2	26.2	31.2	38.1
Book value per share	261.6	271.4	325.1	377.7	442.0

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	17.0	15.5	12.6	10.7	9.2
EV/EBITDA	45.0	46.3	31.4	26.7	22.1
Adjusted P/E	65.0	66.6	46.0	38.6	31.6
P/BV	12.4	11.9	10.0	8.6	7.3

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	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	102.6	102.2	102.2
EBIT margin (EBIT/Revenue)	34.4	30.1	36.2	36.7	38.5
Asset turnover (Revenue/Avg TA)	16.7	16.4	18.4	18.7	18.8
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.2	1.1	1.1
Adjusted ROAE	20.6	18.2	23.6	23.9	25.0

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

Ratio Analysis

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
YoY growth (%)					
Revenue	27.1	9.4	24.0	18.0	16.4
EBITDA	48.5	(3.0)	48.2	18.0	20.7
Adjusted EPS	55.8	(2.4)	44.9	19.1	22.1
Profitability & Return ratios (%)					
EBITDA margin	37.8	33.6	40.1	40.1	41.6
EBIT margin	34.4	30.1	36.2	36.7	38.5
Adjusted profit margin	26.7	23.9	27.9	28.1	29.5
Adjusted ROAE	20.6	18.2	23.6	23.9	25.0
ROCE	19.7	17.5	22.7	23.2	24.4
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%

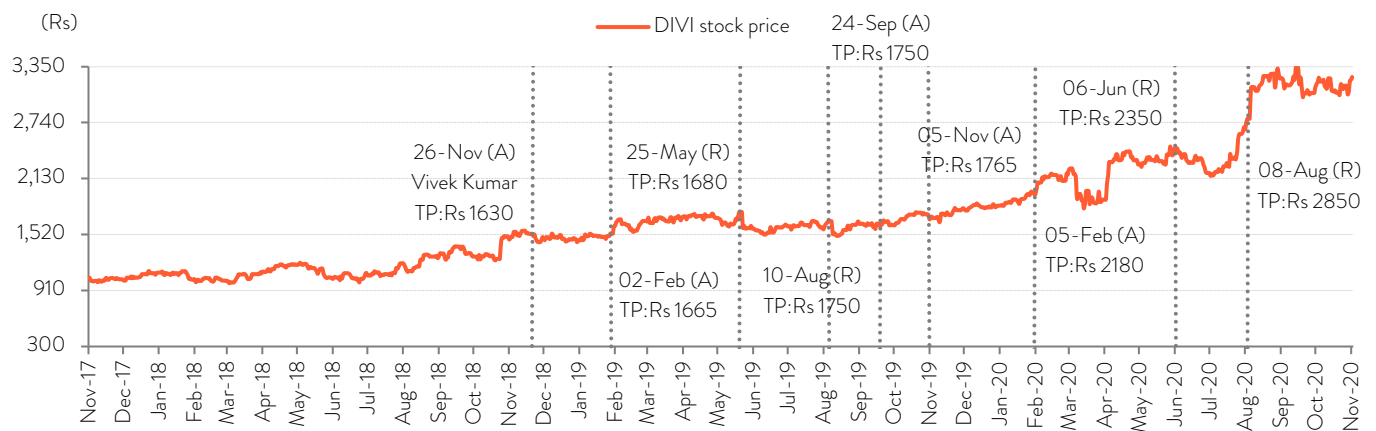
ADD – Expected return from >+5% to +15%

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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