

**BUY**

TP: Rs 5,250 | ▲ 22%

**DIVI'S LABS**

| Pharmaceuticals

| 11 February 2022

## Remarkable quarter; upgrade to BUY

- Q3 surpassed expectations on all fronts with revenue/EBITDA growth at 49%/62% YoY, ahead of consensus by 15%/26%
- Operating leverage helped EBITDA margin expand 360bps YoY to 44.6% despite 250bps gross margin correction
- On rollover and rationalising our target FY24E EV/EBITDA to 27x (vs. 31x), we have a new TP of Rs 5,250 (vs. Rs 5,540); raise from HOLD to BUY

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**Beats consensus estimates by wide margin:** DIVI reported standalone Q3FY22 revenue/PAT of Rs 24.7bn/Rs 9.1bn, a beat of 15%/45% over consensus. The custom synthesis business grew 86% YoY and generic API was up 27% YoY. Custom synthesis, generic APIs and nutraceuticals contributed 50%, 44% and 6% of revenue respectively.

**Capex yielding fruit in challenging times:** In line with the industry, DIVI faced challenges during Q3 such as steep price increases for some raw materials due to the energy crisis in China, but it was able to partly mitigate the headwinds by diversification of procurement sources, long-term contracts with key suppliers, backward integration on key products and selective product offerings. On the logistical front, the company faced limited manpower availability and congestion at ports as well as container shortages, which impacted shipments. However, recent capex for backward integration, debottlenecking and upgrades have minimised supply risk and production disruptions.

**Operating leverage aids EBITDA margin gains despite lower gross margin:** Gross margin for the quarter dipped to 66.5% (-250bps YoY, -40bps QoQ), but lower staff cost at 10% of revenue (-410bps YoY) and reduced SG&A expense at 12% of revenue (-200bps YoY) aided EBITDA margin expansion of 360bps YoY (+300bps QoQ) to 44.6%.

**Raise to BUY:** Given the impressive 9MFY22 performance (revenue/EBITDA up 26%/31% YoY), we raise our FY22 revenue and EBITDA estimates by 3% each. The stock is trading at 25x/21x FY23E/FY24E EV/EBITDA after correcting 11% in the last three months. Given the current high base, capacity utilisation of ~85%, delays at the Vizag plant as well as easing of the pandemic (affecting Molnupiravir demand), we rationalise our target EV/EBITDA multiple to 27x (31x earlier) – in line with the one-year forward consensus multiple. On moving to FY24 valuations, we have a new TP of Rs 5,250 (Rs 5,540 earlier) and upgrade the stock from HOLD to BUY.

## Key changes

Target	Rating
▼	▲

Ticker/Price	DIVI IN/Rs 4,291
Market cap	US\$ 15.1bn
Free float	48%
3M ADV	US\$ 34.4mn
52wk high/low	Rs 5,425/Rs 3,153
Promoter/FPI/DII	52%/21%/16%

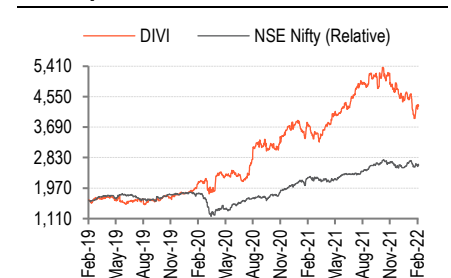
Source: NSE | Price as of 11 Feb 2022

## Key financials

Y/E 31 Mar	FY21A	FY22E	FY23E
Total revenue (Rs mn)	72,261	86,407	99,475
EBITDA (Rs mn)	31,166	36,975	43,562
Adj. net profit (Rs mn)	22,497	26,125	30,900
Adj. EPS (Rs)	84.7	98.4	116.4
Consensus EPS (Rs)	84.7	93.4	113.1
Adj. ROAE (%)	27.1	26.0	26.2
Adj. P/E (x)	50.6	43.6	36.9
EV/EBITDA (x)	36.1	30.4	25.6
Adj. EPS growth (%)	50.9	16.1	18.3

Source: Company, Bloomberg, BOBCAPS Research

## Stock performance



Source: NSE



**Fig 1 – Quarterly performance**

(Rs mn)	Q3FY22	Q3FY21	YoY (%)	Q2FY22	QoQ (%)	9MFY22	9MFY21	YoY (%)
<b>Net Sales</b>	<b>24,668</b>	<b>16,565</b>	<b>48.9</b>	<b>19,679</b>	<b>25.4</b>	<b>63,848</b>	<b>50,802</b>	<b>25.7</b>
<b>EBITDA</b>	<b>10,999</b>	<b>6,785</b>	<b>62.1</b>	<b>8,186</b>	<b>34.4</b>	<b>27,700</b>	<b>21,219</b>	<b>30.5</b>
Depreciation	797	680	-	771	-	2,298	1,848	-
<b>EBIT</b>	<b>10,202</b>	<b>6,105</b>	<b>67.1</b>	<b>7,415</b>	<b>37.6</b>	<b>25,402</b>	<b>19,372</b>	<b>31.1</b>
Interest	2	2	-	2	-	6	5	-
Other Income	166	168	-	191	-	521	430	-
<b>PBT</b>	<b>10,366</b>	<b>6,271</b>	<b>65.3</b>	<b>7,604</b>	<b>36.3</b>	<b>25,916</b>	<b>19,797</b>	<b>30.9</b>
Less: Taxation	1,294	1,687	-	1,541	-	5,453	5,089	-
Less: Minority Interest	0	0	-	0	-	0	0	-
<b>Recurring PAT</b>	<b>9,072</b>	<b>4,584</b>	<b>97.9</b>	<b>6,064</b>	<b>49.6</b>	<b>20,464</b>	<b>14,708</b>	<b>39.1</b>
Exceptional items	0	29	-	0	-	192	(40)	-
<b>Reported PAT</b>	<b>9,072</b>	<b>4,612</b>	<b>96.7</b>	<b>6,064</b>	<b>49.6</b>	<b>20,656</b>	<b>14,668</b>	<b>40.8</b>
<b>Key Ratios (%)</b>			<b>(bps)</b>		<b>(bps)</b>			<b>(bps)</b>
Gross Margin	66.5	69.0	(252)	66.9	(42)	66.8	66.2	56
EBITDA Margin	44.6	41.0	363	41.6	299	43.4	41.8	161
Tax / PBT	12.5	26.9	-	20.3	-	21.0	25.7	-
NPM	36.8	27.7	-	30.8	-	32.1	29.0	-
<b>EPS (Rs)</b>	<b>34.2</b>	<b>17.3</b>	<b>-</b>	<b>22.8</b>	<b>-</b>	<b>77.1</b>	<b>55.4</b>	<b>-</b>

Source: Company, BOBCAPS Research

**Fig 2 – Revenue mix**

(Rs mn)	Q3FY22	Q3FY21	YoY (%)	Q2FY22	QoQ (%)	9MFY22	9MFY21	YoY (%)
Custom Synthesis	12,334	6,626	86.1	10,626	16.1	32,711	20,492	59.6
Generic APIs	10,774	8,489	26.9	7,372	46.1	26,517	25,920	2.3
Nutraceuticals	1,560	1,450	7.6	1,680	(7.1)	4,620	4,390	5.2
<b>Total</b>	<b>24,668</b>	<b>16,565</b>	<b>48.9</b>	<b>19,679</b>	<b>25.4</b>	<b>63,848</b>	<b>50,802</b>	<b>25.7</b>

Source: Company, BOBCAPS Research

## Earnings call highlights

- **Key geographies maintain revenue share:** Exports contributed 92% of DIVI's revenue in Q3FY22 and 90% in 9MFY22. The US and EU contributed 79% in Q3 and 77% in 9M. Generic API accounted for 43% and custom synthesis 57% (59% in CC) for the quarter. Revenue from nutraceuticals stood at Rs 1.6bn in Q3 and Rs 4.6bn in 9M. While plant utilisation was at 80-85%, DIVI has guided for further upsides to revenue in case the opportunity arises as it has an additional 300 reactors to manufacture APIs. Its new Unit-3 plant will be built on 500 acres of land.
- **Key product contributions:** Naproxen contributed 20% of revenue in FY21. Management explained that the strong growth in Q3FY22 revenue and EBITDA margin was due to one custom synthesis product that saw a speedy launch by the originator following market authorisations in key geographies. We believe it was approvals from the USFDA and other key markets for emergency use (EUA) of Merck's Molnupiravir exclusively for mild-to-moderate Covid-19 patients that helped DIVI to outperform estimates in Q3.
- **Industry-wide RM headwinds minimised:** DIVI minimised the impact of supply issues and high raw material prices via better backward integration, as it has been investing on these projects for the last 2-3 years. With integration benefits, API production yields and procurement diversity, the company restricted the fall in Q3 gross margin to just 40bps QoQ and largely safeguarded itself from high freight costs (due to delays in arrival/departure of tanker vessels), production delays and resultant penalty payments due to delayed deliveries.
- **Built-in clause to safeguard from RM price rise:** DIVI has a built-in clause that readjusts prices with clients tied to long-term contracts. Generally, the company signs five-year contracts while its pace of order book execution sets the price based on prevailing RM price movement in global markets. This helps insulate both clients and the company from high volatility in RM prices.
- **Multiple issues plagued RM supply:** Management explained that the energy crisis in China led to a production shortage of bulk intermediates and APIs globally in Q3. Moreover, congestion at Chinese ports affected the availability of specialised tankers, delayed outbound movement of tankers, pushed up prices of RM/ intermediates and led to penalty payments to channel partners or manufacturers due to delayed supply of end products. This impacted DIVI and all its global peers.
- **Capex plans:** The company incurred capex of Rs 1.9bn in 9MFY22 and plans to incur an additional Rs 1bn in Q4FY22. With annual maintenance capex of Rs 1bn, management has guided for an outlay of Rs 10bn-20bn over the next 2-3 years, including investments in greenfield and brownfield projects.

## Valuation methodology

Given DIVI's impressive 9MFY22 performance (revenue/EBITDA up 26%/31% YoY), we raise our FY22 revenue and EBITDA estimates by 3% each. The stock is trading at 25x/21x FY23E/FY24E EV/EBITDA after correcting 11% in the last three months.

Given the current high base, capacity utilisation of ~85%, delays at the Vizag plant as well as easing of the pandemic (affecting Molnupiravir demand), we rationalise our target EV/EBITDA multiple to 27x (31x earlier) – in line with the one-year forward consensus multiple. On rolling forward to FY24 valuations, we have a new TP of Rs 5,250 (Rs 5,540 earlier) and upgrade the stock from HOLD to BUY.

**Fig 3 – Revised estimates**

(Rs bn)	New			Old			Change (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Sales	86.4	99.5	114.7	83.9	97.9	114.3	3.0	1.6	0.4
EBITDA	37.0	43.6	50.8	35.9	42.9	50.6	3.0	1.6	0.4
EBITDA margin (%)	42.8	43.8	44.3	42.8	43.8	44.3	(0bps)	(0bps)	0bps
EPS (Rs)	98.4	116.4	137.2	95.4	114.5	136.6	3.2	1.7	0.4

Source: BOBCAPS Research

**Fig 4 – Key assumptions**

Parameter	FY21	FY22E	FY23E	FY24E
Revenue (Rs bn)	72.3	86.4	99.5	114.7
EBITDA (Rs bn)	31.2	37.0	43.6	50.8
EBITDA Margin (%)	43.1	42.8	43.8	44.3
EPS (Rs)	84.7	98.4	116.4	137.2

Source: Company, BOBCAPS Research

**Fig 5 – Peer comparison**

Company	Ticker	Rating	Target Price (Rs)	EBITDA CAGR FY21-24E (%)	EV/EBITDA (x)		ROE (%)		Target P/E (x)
					FY23E	FY24E	FY23E	FY24E	
DIVI	DIVI IN	BUY	5,250	17.7	25.6	21.9	26.2	26.1	27.0
LAURUS	LAURUS IN	BUY	570	6.8	19.4	16.3	24.5	23.8	17.0
ARBP	ARBP IN	BUY	850	6.9	6.9	5.9	13.3	13.9	7.5

Source: BOBCAPS Research

## 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.
- **Disclosure-related risk:** Limited product-related disclosure due to confidentiality terms is another key risk.

## Sector recommendation snapshot

Company	Ticker	Market Cap (US\$ bn)	Price (Rs)	Target (Rs)	Rating
Ajanta Pharma	AJP IN	2.4	2,065	2,655	BUY
Alembic Pharma	ALPM IN	2.0	752	905	BUY
Alkem Labs	ALKEM IN	5.4	3,431	4,000	HOLD
Aurobindo Pharma	ARBP IN	5.4	700	850	BUY
Cipla	CIPLA IN	10.3	959	1,160	BUY
Divi's Labs	DIVI IN	15.1	4,291	5,250	BUY
Dr Reddy's Labs	DRRD IN	9.5	4,325	4,700	HOLD
Eris Lifesciences	ERIS IN	1.2	689	890	BUY
Laurus Labs	LAURUS IN	3.9	550	570	HOLD
Sun Pharma	SUNP IN	28.0	880	1,045	BUY

Source: BOBCAPS Research, NSE | Price as of 11 Feb 2022

## Financials

### Income Statement

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Total revenue</b>	<b>55,067</b>	<b>72,261</b>	<b>86,407</b>	<b>99,475</b>	<b>1,14,735</b>
EBITDA	19,344	31,166	36,975	43,562	50,818
Depreciation	1,862	2,556	3,001	3,325	3,649
EBIT	17,481	28,611	33,975	40,237	47,169
Net interest inc./(exp.)	(61)	(8)	(10)	0	0
Other inc./(exp.)	1,896	626	868	963	1,399
Exceptional items	0	0	0	0	0
EBT	19,317	29,229	34,833	41,201	48,569
Income taxes	4,406	6,732	8,708	10,300	12,142
Extraordinary items	821	0	0	0	0
Min. int./Inc. from assoc.	0	0	0	0	0
<b>Reported net profit</b>	<b>15,732</b>	<b>22,497</b>	<b>26,125</b>	<b>30,900</b>	<b>36,427</b>
Adjustments	(821)	0	0	0	0
<b>Adjusted net profit</b>	<b>14,911</b>	<b>22,497</b>	<b>26,125</b>	<b>30,900</b>	<b>36,427</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Accounts payables	5,907	7,632	7,192	8,279	9,402
Other current liabilities	5,777	6,874	6,874	6,874	6,874
Provisions	230	278	278	278	278
Debt funds	344	43	0	0	0
Other liabilities	0	0	0	0	0
Equity capital	531	531	531	531	531
Reserves & surplus	72,514	92,464	1,07,428	1,27,271	1,50,662
Shareholders' fund	73,045	92,995	1,07,959	1,27,802	1,51,193
<b>Total liab. and equities</b>	<b>85,303</b>	<b>1,07,821</b>	<b>1,22,302</b>	<b>1,43,232</b>	<b>1,67,746</b>
Cash and cash eq.	1,252	21,704	24,082	34,983	48,559
Accounts receivables	14,134	16,765	20,216	23,273	26,843
Inventories	18,639	21,452	28,408	32,704	37,721
Other current assets	4,550	3,753	3,105	3,105	3,105
Investments	9,714	1	1	1	1
Net fixed assets	27,732	36,947	39,292	41,967	44,318
CWIP	9,196	7,106	7,106	7,106	7,106
Intangible assets	87	92	92	92	92
Deferred tax assets, net	0	0	0	0	0
Other assets	0	0	0	0	0
<b>Total assets</b>	<b>85,303</b>	<b>1,07,821</b>	<b>1,22,302</b>	<b>1,43,232</b>	<b>1,67,746</b>

### Cash Flows

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Cash flow from operations</b>	<b>15,818</b>	<b>22,070</b>	<b>19,591</b>	<b>27,959</b>	<b>32,611</b>
Capital expenditures	(13,083)	(9,105)	(6,000)	(6,000)	(6,000)
Change in investments	9,742	9,713	0	0	0
Other investing cash flows	0	0	0	0	0
<b>Cash flow from investing</b>	<b>(3,342)</b>	<b>608</b>	<b>(6,000)</b>	<b>(6,000)</b>	<b>(6,000)</b>
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(712)	(301)	(43)	0	0
Interest expenses	(61)	(8)	(10)	0	0
Dividends paid	0	0	0	0	0
Other financing cash flows	(12,276)	(1,918)	(11,161)	(11,058)	(13,035)
<b>Cash flow from financing</b>	<b>(13,049)</b>	<b>(2,226)</b>	<b>(11,214)</b>	<b>(11,058)</b>	<b>(13,035)</b>
<b>Chg in cash &amp; cash eq.</b>	<b>(573)</b>	<b>20,452</b>	<b>2,377</b>	<b>10,902</b>	<b>13,576</b>
<b>Closing cash &amp; cash eq.</b>	<b>1,253</b>	<b>21,704</b>	<b>24,082</b>	<b>34,983</b>	<b>48,559</b>

### Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24E
Reported EPS	59.3	84.7	98.4	116.4	137.2
Adjusted EPS	56.2	84.7	98.4	116.4	137.2
Dividend per share	21.2	30.3	35.2	41.6	49.1
Book value per share	275.1	350.3	406.6	481.4	569.5

### Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24E
EV/Sales	20.3	15.6	13.0	11.2	9.7
EV/EBITDA	57.9	36.1	30.4	25.6	21.8
Adjusted P/E	76.4	50.6	43.6	36.9	31.3
P/BV	15.6	12.3	10.6	8.9	7.5

### DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24E
Tax burden (Net profit/PBT)	77.2	77.0	75.0	75.0	75.0
Interest burden (PBT/EBIT)	110.5	102.2	102.5	102.4	103.0
EBIT margin (EBIT/Revenue)	31.7	39.6	39.3	40.4	41.1
Asset turnover (Rev./Avg TA)	16.6	18.7	18.8	18.7	18.4
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.1	1.1	1.1
<b>Adjusted ROAE</b>	<b>20.8</b>	<b>27.1</b>	<b>26.0</b>	<b>26.2</b>	<b>26.1</b>

### Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24E
<b>YoY growth (%)</b>					
Revenue	11.3	31.2	19.6	15.1	15.3
EBITDA	3.3	61.1	18.6	17.8	16.7
Adjusted EPS	10.2	50.9	16.1	18.3	17.9
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	35.1	43.1	42.8	43.8	44.3
EBIT margin	31.7	39.6	39.3	40.4	41.1
Adjusted profit margin	27.1	31.1	30.2	31.1	31.7
Adjusted ROAE	20.8	27.1	26.0	26.2	26.1
ROCE	20.0	26.0	25.1	25.4	25.5
<b>Working capital days (days)</b>					
Receivables	85	85	85	85	85
Inventory	121	120	120	120	120
Payables	94	94	94	94	94
<b>Ratios (x)</b>					
Gross asset turnover	1.3	1.4	1.5	1.5	1.6
Current ratio	3.2	4.3	5.3	6.1	7.0
Net interest coverage ratio	288.5	3,783.6	3,397.5		
<b>Adjusted debt/equity</b>	<b>(0.1)</b>	<b>(0.2)</b>	<b>(0.2)</b>	<b>(0.3)</b>	<b>(0.3)</b>

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

## Disclaimer

### Recommendation scale: Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

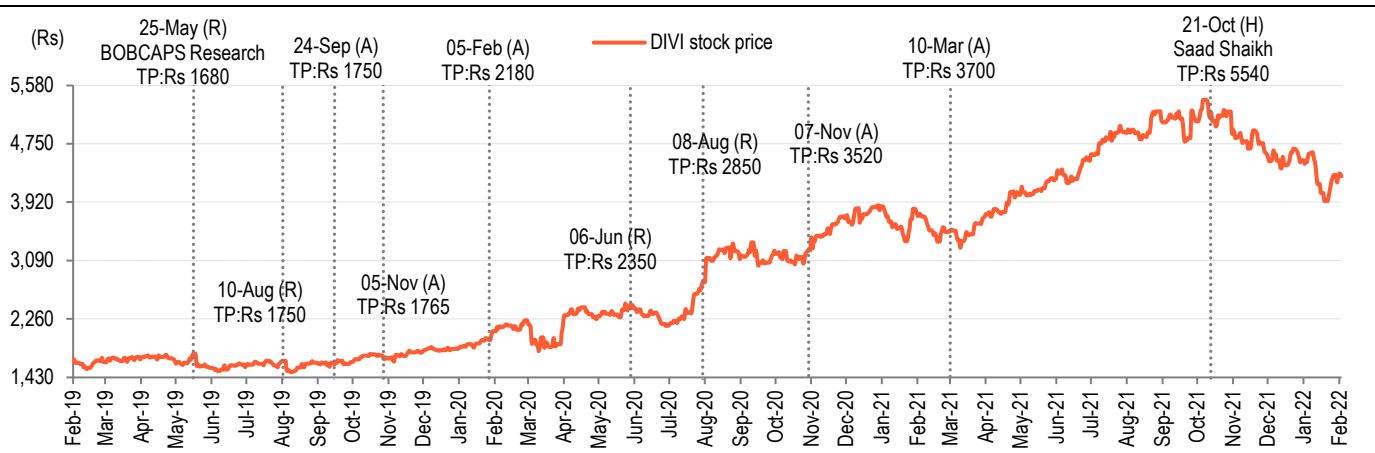
**HOLD** – Expected return from -6% to +15%

**SELL** – Expected return <-6%

**Note:** Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

### Ratings and Target Price (3-year history): DIVI'S LABS (DIVI IN)



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

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