

HOLD
 TP: Rs 3,200 | ▲ 11%

DIVI'S LABS

| Pharmaceuticals

| 04 February 2023

Big miss on revenue and margins

- Q3 disappoints as revenue/PAT of Rs 17bn/Rs 3bn missed consensus by 12%/38%
- Gross/EBITDA margins contracted 7ppt/10ppt QoQ, driving PAT down by 38% QoQ (and 66% YoY)
- We cut FY23/FY24 EPS 12% each and roll to FY25 with a lower 22x target EV/EBITDA for a revised TP of Rs 3,200 (vs. Rs 3,450); retain HOLD

Saad Shaikh

research@bobcaps.in

Revenue disappoints: DIVI reported an 8% QoQ (-32% YoY) decline in revenue to Rs 17.1bn led primarily by an above-expected drop in the custom synthesis business (-14% QoQ). Though the YoY decline can be attributed to a lack of sales from Covid product Molnupiravir, the sequential decline hints at pricing pressure in the core API (active pharma ingredient) business, as management highlighted that API volumes did grow. DIVI expects growth to resume next quarter as demand has shifted to non-Covid products.

Sharp margin contraction: A change in product mix due to a reduced share of custom synthesis business (40% of revenue vs. 43% in Q2FY23 and 57% in Q3FY22) and continued raw material inflation led to gross margin contraction of 700bps QoQ (-10ppt YoY) to 56.7%. This along with negative operating leverage caused EBITDA margin to drop 10ppt QoQ (-21ppt YoY) to 23.9% – among the lowest levels for the company. Management expects increasing volume trends coupled with easing raw material prices to aid margin improvement ahead.

PAT contracts 38% YoY: Margin contraction coupled with a higher tax rate of 33%, up from 21% in Q2FY23 and 12% in Q3FY22, impacted net profit which declined 38% QoQ (-66% YoY), falling 38% short of consensus estimates. This was despite higher other income and forex gains (at Rs 467mn vs. Rs 308mn in Q2FY23 and a loss of Rs 310mn in Q3FY22).

Maintain HOLD; TP cut to Rs 3,200: Given the delays at new plants, reduced margins, the absence of abnormal pandemic-driven growth and a disappointing Q3FY23, we scale back our FY23-FY24 EPS estimates by 12% each. Further, to reflect the margin pressures and near-term challenges, we pare our target EV/EBITDA multiple to 22x (from 24x) – a discount of 15% to the stock's 5Y average, yielding a reduced TP of Rs 3,200 (vs. Rs 3,450) as we roll over to FY25 valuations. Maintain HOLD on limited upside potential.

Key changes

Target	Rating
▼	◀ ▶

Ticker/Price	DIVI IN/Rs 2,884
Market cap	US\$ 9.4bn
Free float	48%
3M ADV	US\$ 23.3mn
52wk high/low	Rs 4,641/Rs 2,795
Promoter/FPI/DII	52%/21%/16%

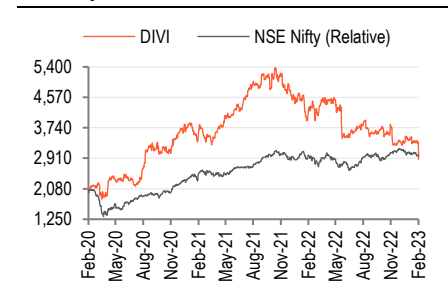
Source: NSE | Price as of 3 Feb 2023

Key financials

Y/E 31 Mar	FY22A	FY23E	FY24E
Total revenue (Rs mn)	89,598	78,935	89,379
EBITDA (Rs mn)	38,819	27,667	32,668
Adj. net profit (Rs mn)	29,199	20,624	23,314
Adj. EPS (Rs)	110.0	77.7	87.8
Consensus EPS (Rs)	110.0	82.5	95.2
Adj. ROAE (%)	27.8	17.3	18.1
Adj. P/E (x)	26.2	37.1	32.8
EV/EBITDA (x)	19.3	26.8	22.3
Adj. EPS growth (%)	47.2	(29.4)	13.0

Source: Company, Bloomberg, BOBCAPS Research

Stock performance



Source: NSE



Fig 1 – Quarterly performance

(Rs mn)	Q3FY23	Q2FY22	YoY (%)	Q2FY23	QoQ (%)	9MFY23	9MFY22	YoY (%)
Net Sales	17,077	24,932	(31.5)	18,545	(7.9)	58,167	64,414	(9.7)
EBITDA	4,083	11,282	(63.8)	6,210	(34.3)	18,760	28,054	(33.1)
Depreciation	868	799	-	857	-	2,562	2,305	-
EBIT	3,215	10,483	(69.3)	5,353	(39.9)	16,199	25,749	(37.1)
Interest	1	2	-	2	-	4	7	-
Other Income	676	166	-	493	-	1,488	521	-
PBT	3,890	10,647	(63.5)	5,844	(33.4)	17,682	26,262	(32.7)
Less: Taxation	1,288	1,314	-	1,216	-	3,997	5,420	-
Less: Minority Interest	0	0	-	0	-	0	0	-
Recurring PAT	2,601	9,332	(72.1)	4,628	(43.8)	13,685	20,843	(34.3)
Exceptional items	467	(310)	-	308	-	1,339	(185)	-
Reported PAT	3,068	9,022	(66.0)	4,936	(37.9)	15,024	20,658	(27.3)
Key Ratios (%)			(bps)		(bps)			(bps)
Gross Margin	56.7	66.6	(996)	63.6	(693)	61.7	67.0	(523)
EBITDA Margin	23.9	45.2	(2,134)	33.5	(958)	32.3	43.6	(1,130)
Tax / PBT	33.1	12.3	-	20.8	-	22.6	20.6	-
NPM	15.2	37.4	-	25.0	-	23.5	32.4	-
EPS (Rs)	9.8	35.2	-	17.4	-	51.6	78.5	-

Source: Company, BOBCAPS Research

Fig 2 – Segmental performance

(Rs mn)	Q3FY23	Q2FY22	YoY (%)	Q2FY23	QoQ (%)	9MFY23	9MFY22	YoY (%)
Custom Synthesis	6,831	14,211	(51.9)	7,975	(14.3)	26,754	34,747	(23.0)
Generic APIs	8,646	9,061	(4.6)	8,941	(3.3)	26,323	24,947	5.5
Nutraceuticals	1,600	1,660	(3.6)	1,630	(1.8)	5,090	4,720	7.8
Total	17,077	24,932	(31.5)	18,545	(7.9)	58,167	64,414	(9.7)

Source: Company, BOBCAPS Research

Earnings call highlights

- **Revenue:** Management noted a clear shift in demand from Covid to non-Covid products in Q3FY23. DIVI is seeing double-digit revenue growth in some generic products and indicated that most of the growth in its top generics was volume-led.

In terms of mix, generic and custom synthesis revenue share was at 60% and 40% respectively in Q3. Nutraceutical revenue stood at Rs 1.6bn. Exports accounted for 87% of sales, with the US and Europe forming 69% of export sales.

- **Raw materials:** Raw material prices have softened slightly after Q3. Logistic and freight costs are improving for both air and sea modes.
- **Contrast Media:** DIVI indicated that customers base for contrast media is consolidated among a few players. Contribution will be higher from contrast media from Q1FY24.
- **API:** It is currently working on two new generic APIs, which it expects will start contributing meaningfully from Q1FY24.
- **Kakinada plant:** The company has received all government clearances for the Kakinada plant and expects it to start contributing in 2-3 years' time.
- **Investments:** Management plans to invest Rs 10bn initially towards newer technologies and chemistries such as vapour phase chemistry, continuous flow chemistry, photochemistry and contrast media.
- New blocks are being qualified and validated, and commercial production is scheduled to start soon.

Valuation methodology

Given the delays at new plants, reduced margins, the absence of abnormal pandemic-driven growth and a disappointing Q3FY23, we scale back our FY23-FY24 EPS estimates by 12% each. Further, to reflect the margin pressures and near-term challenges, we pare our target EV/EBITDA multiple to 22x (from 24x) – a discount of 15% to the stock’s five-year average, yielding a reduced TP of Rs 3,200 (vs. Rs 3,450) as we roll over to FY25 valuations. Maintain HOLD on limited upside potential.

Fig 3 – Revised estimates

(Rs bn)	New			Old			Change (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Sales	78.9	89.4	100.0	86.1	94.7	NA	(8.3)	(5.6)	-
EBITDA	27.7	32.7	37.0	31.9	37.0	NA	(13.2)	(11.6)	-
EBITDA margin (%)	35.0	36.5	37.0	37.0	39.0	NA	(200bps)	(250bps)	-
EPS (Rs)	77.7	88.2	99.8	88.8	100.4	NA	(12.5)	(12.2)	-

Source: BOBCAPS Research

Fig 4 – Key assumptions

Revenue (Rs bn)	FY22	FY23E	FY24E	FY25E
Generic API	30.4	35.0	39.2	43.9
CS	52.9	37.0	42.6	47.7
Nutraceuticals	6.3	6.9	7.6	8.4

Source: Company, BOBCAPS Research

Key risks

Key upside risks to our estimates are:

- earlier-than-expected revival in generic API business,
- softening of input costs,
- faster-than-expected progress on delayed facilities.

Key downside risks are:

- continued elevation of input costs,
- pressure on API pricing, and
- delay in business from custom synthesis customers.

Sector recommendation snapshot

Company	Ticker	Market Cap (US\$ bn)	Price (Rs)	Target (Rs)	Rating
Ajanta Pharma	AJP IN	1.8	1,175	1,470	HOLD
Alembic Pharma	ALPM IN	1.3	535	615	HOLD
Alkem Labs	ALKEM IN	4.5	3,051	2,700	SELL
Aurobindo Pharma	ARBP IN	2.9	404	635	BUY
Cipla	CIPLA IN	10.1	1,022	1,250	BUY
Divi's Labs	DIVI IN	9.4	2,884	3,200	HOLD
Dr Reddy's Labs	DRRD IN	8.9	4,358	4,700	HOLD
Eris Lifesciences	ERIS IN	1.0	625	810	BUY
Glenmark Life Sciences	GLS IN	0.6	376	585	BUY
Laurus Labs	LAURUS IN	2.2	331	540	HOLD
Lupin	LPC IN	4.1	739	700	HOLD
Sun Pharma	SUNP IN	30.1	1,028	1,100	HOLD

Source: BOBCAPS Research, NSE | Price as of 3 Feb 2023

Financials

Income Statement

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23E	FY24E	FY25E
Total revenue	69,694	89,598	78,935	89,379	99,952
EBITDA	28,599	38,819	27,667	32,668	37,032
Depreciation	2,556	3,115	3,561	4,007	4,548
EBIT	26,044	35,704	24,106	28,661	32,484
Net interest inc./(exp.)	(9)	(8)	0	0	0
Other inc./(exp.)	626	733	2,000	850	700
Exceptional items	0	0	0	0	0
EBT	26,660	36,429	26,106	29,511	33,184
Income taxes	6,818	7,231	5,482	6,197	6,969
Extraordinary items	0	406	1,500	0	0
Min. int./Inc. from assoc.	0	0	0	0	0
Reported net profit	19,843	29,604	22,124	23,314	26,215
Adjustments	0	(406)	(1,500)	0	0
Adjusted net profit	19,843	29,199	20,624	23,314	26,215

Balance Sheet

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23E	FY24E	FY25E
Accounts payables	7,632	7,957	7,880	8,805	9,715
Other current liabilities	6,874	8,192	8,192	8,192	8,192
Provisions	278	309	309	309	309
Debt funds	43	8	0	0	0
Other liabilities	0	0	0	0	0
Equity capital	531	531	531	531	531
Reserves & surplus	92,415	1,16,751	1,21,053	1,35,933	1,52,664
Shareholders' fund	92,946	1,17,282	1,21,584	1,36,464	1,53,195
Total liab. and equities	1,07,772	1,33,747	1,37,964	1,53,769	1,71,411
Cash and cash eq.	21,704	28,189	42,069	46,592	53,428
Accounts receivables	16,765	24,239	18,062	20,452	22,871
Inventories	21,452	28,286	21,910	24,808	27,743
Other current assets	3,704	4,363	4,314	4,314	4,314
Investments	1	720	720	720	720
Net fixed assets	36,947	43,142	46,081	52,074	57,525
CWIP	7,106	4,699	4,699	4,699	4,699
Intangible assets	92	109	109	109	109
Deferred tax assets, net	0	0	0	0	0
Other assets	0	0	0	0	0
Total assets	1,07,772	1,33,747	1,37,964	1,53,769	1,71,411

Cash Flows

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23E	FY24E	FY25E
Cash flow from operations	18,634	19,144	38,209	22,957	26,320
Capital expenditures	(9,105)	(7,574)	(6,500)	(10,000)	(10,000)
Change in investments	9,713	(719)	0	0	0
Other investing cash flows	0	0	0	0	0
Cash flow from investing	608	(8,293)	(6,500)	(10,000)	(10,000)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(301)	(35)	(8)	0	0
Interest expenses	(9)	(8)	0	0	0
Dividends paid	0	0	0	0	0
Other financing cash flows	1,520	(4,323)	(17,821)	(8,434)	(9,484)
Cash flow from financing	1,210	(4,366)	(17,830)	(8,434)	(9,484)
Chg in cash & cash eq.	20,452	6,484	13,880	4,523	6,836
Closing cash & cash eq.	21,704	28,189	42,069	46,592	53,428

Per Share

Y/E 31 Mar (Rs)	FY21A	FY22A	FY23E	FY24E	FY25E
Reported EPS	74.7	111.5	83.3	87.8	98.7
Adjusted EPS	74.7	110.0	77.7	87.8	98.7
Dividend per share	27.0	40.3	30.1	31.8	35.7
Book value per share	350.1	441.7	457.9	514.0	577.0

Valuations Ratios

Y/E 31 Mar (x)	FY21A	FY22A	FY23E	FY24E	FY25E
EV/Sales	10.8	8.4	9.4	8.2	7.2
EV/EBITDA	26.2	19.3	26.8	22.3	19.5
Adjusted P/E	38.6	26.2	37.1	32.8	29.2
P/BV	8.2	6.5	6.3	5.6	5.0

DuPont Analysis

Y/E 31 Mar (%)	FY21A	FY22A	FY23E	FY24E	FY25E
Tax burden (Net profit/PBT)	74.4	80.2	79.0	79.0	79.0
Interest burden (PBT/EBIT)	102.4	102.0	108.3	103.0	102.2
EBIT margin (EBIT/Revenue)	37.4	39.8	30.5	32.1	32.5
Asset turnover (Rev./Avg TA)	18.1	18.5	14.5	15.3	15.4
Leverage (Avg TA/Avg Equity)	1.2	1.1	1.1	1.1	1.1
Adjusted ROAE	24.0	27.8	17.3	18.1	18.1

Ratio Analysis

Y/E 31 Mar	FY21A	FY22A	FY23E	FY24E	FY25E
YoY growth (%)					
Revenue	29.2	28.6	(11.9)	13.2	11.8
EBITDA	57.0	35.7	(28.7)	18.1	13.4
Adjusted EPS	43.9	47.2	(29.4)	13.0	12.4
Profitability & Return ratios (%)					
EBITDA margin	41.0	43.3	35.0	36.5	37.0
EBIT margin	37.4	39.8	30.5	32.1	32.5
Adjusted profit margin	28.5	32.6	26.1	26.1	26.2
Adjusted ROAE	24.0	27.8	17.3	18.1	18.1
ROCE	23.1	26.7	16.6	17.5	17.6
Working capital days (days)					
Receivables	81	84	84	84	84
Inventory	105	101	101	101	101
Payables	106	96	96	96	96
Ratios (x)					
Gross asset turnover	1.3	1.4	1.1	1.1	1.1
Current ratio	4.3	5.2	5.3	5.6	5.9
Net interest coverage ratio	2,993.5	4,463.0	-	-	-
Adjusted debt/equity	(0.2)	(0.2)	(0.4)	(0.3)	(0.4)

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

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

BUY – Expected return >+15%

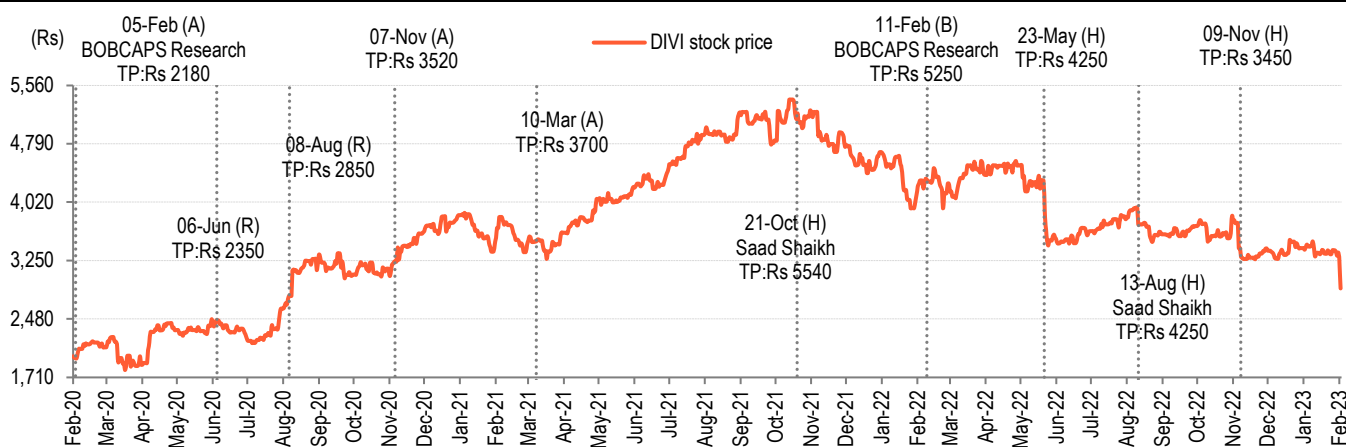
HOLD – Expected return from -6% to +15%

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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