

**REDUCE**

TP: Rs 2,350 | ▼ 4%

**DIVI'S LABS**

Pharmaceuticals

06 June 2020

## Q4 disappoints – downgrade to REDUCE

Divi's Labs (DIVI) saw a steep 19% EBITDA miss as high gross margins (+200bps QoQ) were negated by staff/SGA cost, leading to subpar Q4 operating margins. PAT was boosted by tax reversals. Gross margin benefitted from better product mix within generic APIs; the CS sales mix was flat QoQ. DIVI expects healthy growth in FY21 but subdued EBITDA margins of 34-36% (38% guided earlier). We cut FY21/FY22 EPS 8-10% and revise our TP to Rs 2,350, based on 22x FY22 EV/EBITDA. Cut from ADD to REDUCE on rich valuations.

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**Q4 EBITDA miss, FY21 margin improvement to be subdued:** EBITDA recovery QoQ was far weaker than expected due to lower revenues. Margins were soft at 32.6% (38% est.) despite strong gross margins of 63% (+200bps QoQ). Staff/SGA were up 11%/28% QoQ led by increased manpower for new units and higher compliance cost, repairs of old plants and CSR (Rs 200mn). CS business was up 10% YoY (revenue share flat QoQ at 41%) and generic APIs also increased 10% YoY. Management expect a softer Q1 due to logistical disruptions, but sees healthy revenue growth in FY21. EBITDA margins are guided to be subdued at 34-36% (vs. 38% guided earlier) given lower operating leverage on new capex and higher staff cost, driving our FY21/FY22 EPS cuts.

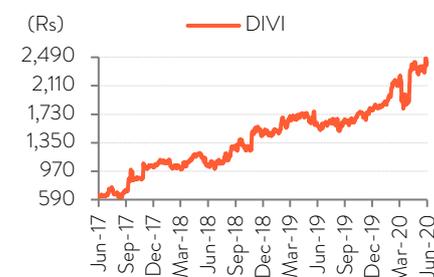
**Earnings call highlights:** (1) Q4 had a Rs 571mn forex gain. (2) Implementation of total capex of Rs 16.9bn is on track. (2) Q4/FY20 capitalisation stood at Rs 6.5bn/Rs 8.7bn (3) Naproxen market share is stable at 65% and continues to see further expansion in volumes. (4) Tax rate for FY21 pegged at ~25%.

**Cut to REDUCE:** While DIVI's execution track record is impressive, we believe the stock could underperform in the midterm in view of stretched valuations and delayed earnings benefit on new capex (we cut FY21/FY22 EPS 8-10%). The stock is trading at 34x FY22E EPS vs. the 3Y historical band of 20-35x.

Ticker/Price	DIVI IN/Rs 2,460
Market cap	US\$ 8.6bn
Shares o/s	266mn
3M ADV	US\$ 27.3mn
52wk high/low	Rs 2,538/Rs 1,466
Promoter/FPI/DII	52%/17%/17%

Source: NSE

## STOCK PERFORMANCE



## KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
Total revenue (Rs mn)	38,906	49,462	54,088	61,595	72,773
EBITDA (Rs mn)	12,608	18,719	18,150	22,517	27,913
Adj. net profit (Rs mn)	8,482	13,219	12,903	15,409	19,418
Adj. EPS (Rs)	31.9	49.8	48.6	58.0	73.1
Adj. EPS growth (%)	(22.9)	55.8	(2.4)	19.4	26.0
Adj. ROAE (%)	15.0	20.6	18.2	19.7	21.5
Adj. P/E (x)	77.0	49.4	50.6	42.4	33.6
EV/EBITDA (x)	50.8	33.9	34.9	28.3	23.0

Source: Company, BOBCAPS Research

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**FIG 1 – QUARTERLY PERFORMANCE**

(Rs mn)	Q4FY20	Q4FY19	YoY (%)	Q3FY20	QoQ (%)	Q4FY20E	Var (%)	FY20P	FY19	YoY (%)
<b>Net Sales</b>	<b>13,762</b>	<b>12,564</b>	<b>9.5</b>	<b>13,904</b>	<b>(1.0)</b>	<b>14,599</b>	<b>(5.7)</b>	<b>53,104</b>	<b>48,796</b>	<b>8.8</b>
<b>EBITDA</b>	<b>4,486</b>	<b>4,180</b>	<b>7.3</b>	<b>4,969</b>	<b>(9.7)</b>	<b>5,515</b>	<b>(18.7)</b>	<b>18,155</b>	<b>18,487</b>	<b>(1.8)</b>
Depreciation	495	423	-	467	-	467	-	1,859	1,693	-
<b>EBIT</b>	<b>3,991</b>	<b>3,757</b>	<b>6.2</b>	<b>4,502</b>	<b>(11.4)</b>	<b>5,048</b>	<b>-</b>	<b>16,296</b>	<b>16,794</b>	<b>(3.0)</b>
Interest	4	1	-	16	-	5	-	61	35	-
Other Income	194	417	-	224	-	224	-	1,079	1,255	-
<b>PBT</b>	<b>4,181</b>	<b>4,173</b>	<b>0.2</b>	<b>4,711</b>	<b>(11.2)</b>	<b>5,267</b>	<b>-</b>	<b>17,314</b>	<b>18,014</b>	<b>(3.9)</b>
Less: Taxation	834	1,210	-	1,282	-	1,475	(641)	4,406	5,005	-
Less: Minority Interest	0	0	-	0	-	0	-	0	0	-
<b>Recurring PAT</b>	<b>3,347</b>	<b>2,963</b>	<b>13.0</b>	<b>3,429</b>	<b>(2.4)</b>	<b>3,792</b>	<b>(11.7)</b>	<b>12,908</b>	<b>13,009</b>	<b>(0.8)</b>
Exceptional items	571	(70)	-	179	-	0	-	819	315	-
<b>Reported PAT</b>	<b>3,918</b>	<b>2,893</b>	<b>35.4</b>	<b>3,608</b>	<b>8.6</b>	<b>3,792</b>	<b>3.3</b>	<b>13,728</b>	<b>13,324</b>	<b>3.0</b>
<b>Key Ratios (%)</b>										
Gross Margin	62.9	60.0	-	60.6	-	61.0	-	60.7	62.3	-
EBITDA Margin	32.6	33.3	-	35.7	-	37.8	-	34.2	37.9	-
Tax / PBT	19.9	29.0	-	27.2	-	28.0	-	25.4	27.8	-
NPM	24.3	23.6	-	24.7	-	26.0	-	24.3	26.7	-
<b>EPS (Rs)</b>	<b>12.6</b>	<b>11.2</b>	<b>-</b>	<b>12.9</b>	<b>-</b>	<b>14.3</b>	<b>-</b>	<b>48.6</b>	<b>49.0</b>	<b>-</b>

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. However, given emerging tailwinds in the US generics business (price stabilisation, drug shortage opportunity) and reasonable valuations, we see better risk-reward in large-cap generic players as compared to DIVI over the medium term.

DIVI’s valuations are expensive, with the stock trading at 34x FY22E earnings vs. the three-year historical P/E band of 20-35x for earnings growth of 23% over the next two years. We cut our FY21/FY22 EPS estimates by 8-10% to Rs 58/Rs 73, factoring in lower EBITDA margins and delay in operating leverage on the new capex.

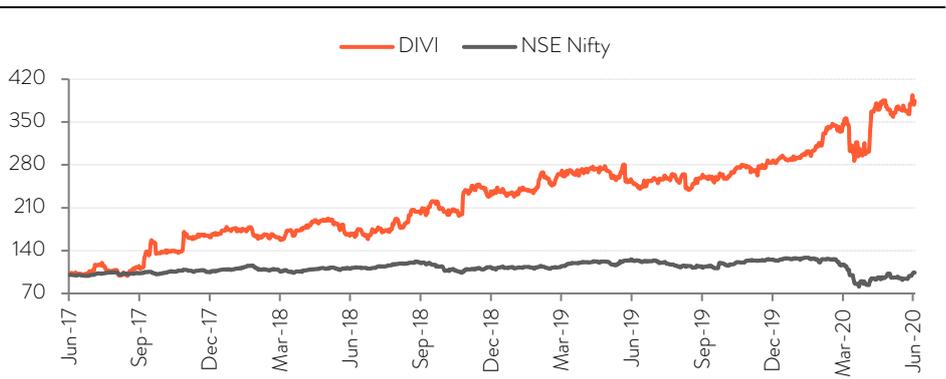
Given unfavourable risk-reward, we downgrade our rating to REDUCE from ADD with a revised Mar’21 target price of Rs 2,350 (from Rs 2,180), based on a target FY22E EV/EBITDA multiple of 22x (vs. 19x earlier), which represents an implied P/E of 32x. The increase in target multiple is in line with broader sectoral multiple expansion.

**FIG 2 – REVISED ESTIMATES**

(Rs bn)	New			Old			Change (%)		
	FY20P	FY21E	FY22E	FY20P	FY21E	FY22E	FY20P	FY21E	FY22E
Sales	54	62	73	55	64	74	(1.1)	(3.5)	(1.8)
EBITDA	18	23	28	20	25	30	(8.5)	(8.3)	(6.9)
EBITDA margin (%)	33.6	36.6	38.4	36.2	38.4	40.4	(268bps)	(188bps)	(208bps)
EPS (Rs)	49	58	73	52	64	79	(7.2)	(9.9)	(7.5)

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	FY20P	FY21E	FY22E
<b>Total revenue</b>	<b>38,906</b>	<b>49,462</b>	<b>54,088</b>	<b>61,595</b>	<b>72,773</b>
EBITDA	12,608	18,719	18,150	22,517	27,913
Depreciation	1,424	1,689	1,859	2,603	2,694
EBIT	11,184	17,030	16,291	19,914	25,220
Net interest income/(expenses)	(13)	(35)	(61)	0	0
Other income/(expenses)	855	1,247	1,079	632	671
Exceptional items	0	0	0	0	0
EBT	12,025	18,242	17,309	20,546	25,890
Income taxes	3,543	5,023	4,406	5,136	6,473
Extraordinary items	280	309	819	0	0
Min. int./Inc. from associates	0	0	0	0	0
<b>Reported net profit</b>	<b>8,762</b>	<b>13,528</b>	<b>13,723</b>	<b>15,409</b>	<b>19,418</b>
Adjustments	(280)	(309)	(819)	0	0
<b>Adjusted net profit</b>	<b>8,482</b>	<b>13,219</b>	<b>12,903</b>	<b>15,409</b>	<b>19,418</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Accounts payables	4,112	4,922	5,789	5,786	6,651
Other current liabilities	3,679	4,797	5,730	5,730	5,730
Provisions	158	143	451	0	0
Debt funds	631	1,056	336	0	0
Other liabilities	0	0	0	0	0
Equity capital	531	531	531	531	531
Reserves & surplus	58,639	68,932	71,520	83,715	95,903
Shareholders' fund	59,170	69,463	72,051	84,246	96,434
<b>Total liabilities and equities</b>	<b>67,750</b>	<b>80,381</b>	<b>84,357</b>	<b>95,762</b>	<b>108,815</b>
Cash and cash eq.	1,124	1,152	1,225	2,197	4,330
Accounts receivables	10,143	11,633	14,133	14,671	17,334
Inventories	13,506	17,723	18,638	20,250	23,925
Other current assets	2,983	4,698	3,750	3,358	3,358
Investments	18,892	19,455	9,713	9,713	9,713
Net fixed assets	19,873	20,761	27,662	32,059	32,365
CWIP	1,197	4,919	9,196	13,473	17,750
Intangible assets	33	40	40	40	40
Deferred tax assets, net	0	0	0	0	0
Other assets	0	0	0	0	0
<b>Total assets</b>	<b>67,750</b>	<b>80,381</b>	<b>84,357</b>	<b>95,762</b>	<b>108,815</b>

Source: Company, BOBCAPS Research

**Cash Flows**

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Net income + Depreciation	10,186	15,217	15,582	18,012	22,111
Interest expenses	13	35	61	0	0
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(2,508)	(5,808)	(907)	(2,213)	(5,472)
Other operating cash flows	0	0	0	0	0
<b>Cash flow from operations</b>	<b>7,692</b>	<b>9,443</b>	<b>14,735</b>	<b>15,800</b>	<b>16,639</b>
Capital expenditures	(2,500)	(6,307)	(13,037)	(11,277)	(7,277)
Change in investments	(2,585)	(563)	9,742	0	0
Other investing cash flows	0	0	0	0	0
<b>Cash flow from investing</b>	<b>(5,085)</b>	<b>(6,870)</b>	<b>(3,295)</b>	<b>(11,277)</b>	<b>(7,277)</b>
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	274	425	(720)	(336)	0
Interest expenses	(13)	(35)	(61)	0	0
Dividends paid	0	0	0	0	0
Other financing cash flows	(2,530)	(2,936)	(10,587)	(3,214)	(7,229)
<b>Cash flow from financing</b>	<b>(2,269)</b>	<b>(2,546)</b>	<b>(11,368)</b>	<b>(3,550)</b>	<b>(7,229)</b>
<b>Changes in cash and cash eq.</b>	<b>338</b>	<b>28</b>	<b>73</b>	<b>973</b>	<b>2,133</b>
<b>Closing cash and cash eq.</b>	<b>1,124</b>	<b>1,152</b>	<b>1,225</b>	<b>2,197</b>	<b>4,330</b>

**Per Share**

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20P	FY21E	FY22E
Reported EPS	33.0	51.0	51.7	58.0	73.1
Adjusted EPS	31.9	49.8	48.6	58.0	73.1
Dividend per share	12.0	19.0	19.2	21.6	27.2
Book value per share	222.9	261.6	271.4	317.3	363.2

**Valuations Ratios**

Y/E 31 Mar (x)	FY18A	FY19A	FY20P	FY21E	FY22E
EV/Sales	16.5	12.8	11.7	10.4	8.8
EV/EBITDA	50.8	33.9	34.9	28.3	23.0
Adjusted P/E	77.0	49.4	50.6	42.4	33.6
P/BV	11.0	9.4	9.1	7.8	6.8

**DuPont Analysis**

Y/E 31 Mar (%)	FY18A	FY19A	FY20P	FY21E	FY22E
Tax burden (Net profit/PBT)	70.5	72.5	74.5	75.0	75.0
Interest burden (PBT/EBIT)	107.5	107.1	106.2	103.2	102.7
EBIT margin (EBIT/Revenue)	28.7	34.4	30.1	32.3	34.7
Asset turnover (Revenue/Avg TA)	15.0	16.7	16.4	17.1	17.8
Leverage (Avg TA/Avg Equity)	1.1	1.2	1.2	1.2	1.1
Adjusted ROAE	15.0	20.6	18.2	19.7	21.5

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

**Ratio Analysis**

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
<b>YoY growth (%)</b>					
Revenue	(4.3)	27.1	9.4	13.9	18.1
EBITDA	(15.1)	48.5	(3.0)	24.1	24.0
Adjusted EPS	(22.9)	55.8	(2.4)	19.4	26.0
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	32.4	37.8	33.6	36.6	38.4
EBIT margin	28.7	34.4	30.1	32.3	34.7
Adjusted profit margin	21.8	26.7	23.9	25.0	26.7
Adjusted ROAE	15.0	20.6	18.2	19.7	21.5
ROCE	14.5	19.7	17.5	19.0	20.9
<b>Working capital days (days)</b>					
Receivables	90	80	87	87	87
Inventory	125	115	123	120	120
Payables	95	90	93	93	93
<b>Ratios (x)</b>					
Gross asset turnover	1.3	1.5	1.3	1.3	1.4
Current ratio	3.5	3.6	3.2	3.5	4.0
Net interest coverage ratio	840.9	486.6	268.8		
Adjusted debt/equity	(0.3)	(0.3)	(0.1)	(0.1)	(0.1)

Source: Company, BOBCAPS Research

## Disclaimer

### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

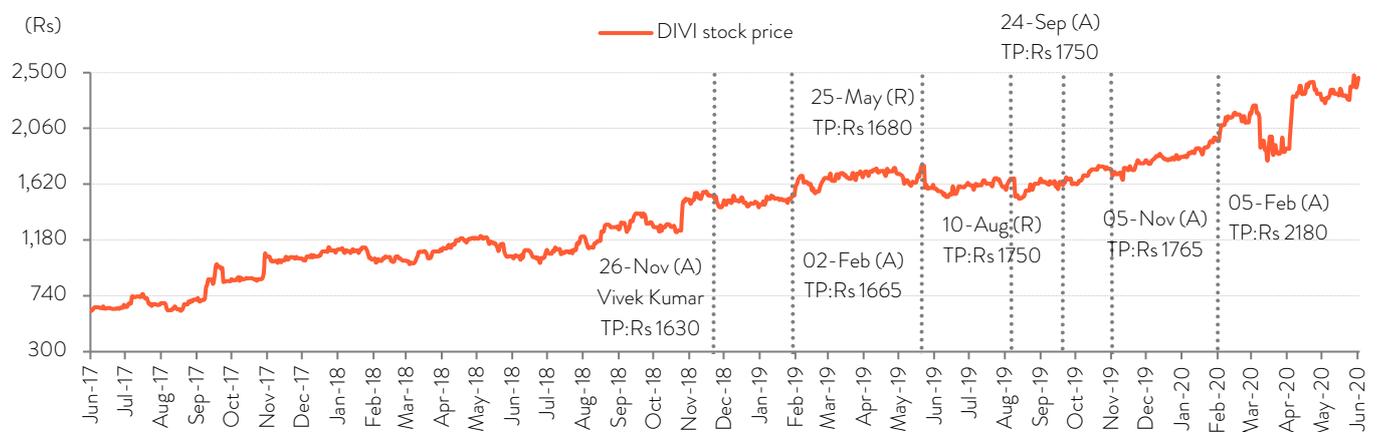
**ADD** – Expected return from >+5% to +15%

**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)

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

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