

REDUCE

TP: Rs 1,750 | ▲ 5%

DIVI'S LABS

Pharmaceuticals

10 August 2019

Lacklustre Q1, normalcy expected from Q3

Q1FY20 saw a lackluster with a revenue/EBITDA miss of 2%/5% led by continued consumption of high-cost RM and a weak product mix (lower CS contribution at 41%, flat QoQ). DIVI expects margin normalcy to be restored from Q3, while sales run-rate should improve from Q2. We believe the asking rate for the rest of the year is steep given FY20 guidance of 10% revenue growth and 37-38% margins. Maintain REDUCE; on rollover, we have a Sep'20 TP of Rs 1,750 (vs. Rs 1,680). Expect the stock to be weak in the medium term.

Vivek Kumar

research@bobcaps.in

Subdued gross margins drive EBITDA miss: Sequentially, Q1 EBITDA margins were subdued at 33.7% (34.8% est.) led by (1) higher material price from China leading to lower gross margins of 60.2% (flat QoQ), and (2) a weak product mix – CS business grew 9% YoY with Sales mix at 41%, flat QoQ. Work is progressing on the backward integration of several APIs, but the company procured high-cost inventory to ensure consistency of supplies, which should be liquidated by Q2. Hence, normal operational efficiency should be restored from Q3 onwards, while the sales run-rate should improve from Q2. Management retained its guidance of 37-38% margins for FY20.

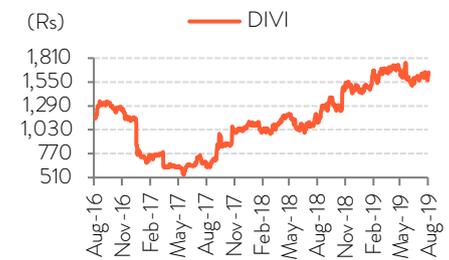
Other Q1 highlights: (1) FDA issued zero 483s for Unit-2 during the May'19 inspection. (2) Q1 forex loss was Rs 70mn. (3) Implementation of total capex of Rs 16.9bn is on track. (4) Q1 capitalisation was Rs 1.12bn – expected total capitalisation is at Rs 12bn in FY20 incl. CWIP. (5) Balance sheet inventory rose Rs 1.5bn QoQ which is high cost and will be liquidated in Q2.

Retain REDUCE on full valuations: We maintain our FY20/FY21 EPS estimates of Rs 54/65 (Q1 EPS was Rs 10.3). Retain REDUCE due to rich valuations – 26x FY21E earnings vs. the 3Y/5Y historical mean of 23-24x, slow growth in FY20, and limited scope for earnings upgrades.

Ticker/Price	DIVI IN/Rs 1,665
Market cap	US\$ 6.2bn
Shares o/s	266mn
3M ADV	US\$ 13.7mn
52wk high/low	Rs 1,775/Rs 1,080
Promoter/FPI/DII	52%/17%/17%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Adj. net profit (Rs mn)	8,482	13,219	14,331	17,173	21,093
Adj. EPS (Rs)	31.9	49.8	54.0	64.7	79.4
Adj. EPS growth (%)	(22.9)	55.8	8.4	19.8	22.8
Adj. ROAE (%)	15.0	20.5	19.8	21.4	22.8
Adj. P/E (x)	52.1	33.4	30.8	25.7	21.0
EV/EBITDA (x)	33.7	22.6	20.7	17.0	13.8

Source: Company, BOBCAPS Research

BOB Capital Markets Ltd is a wholly owned subsidiary of Bank of Baroda

Important disclosures, including any required research certifications, are provided at the end of this report.



FIG 1 – QUARTERLY PERFORMANCE

(Rs mn)	Q1FY20	Q1FY19	YoY (%)	Q4FY19	QoQ (%)	Q1FY20E	Var (%)
Net Sales	11,399	9,953	14.5	12,564	(9.3)	11,633	(2.0)
EBITDA	3,846	3,520	9.3	4,180	(8.0)	4,047	(5.0)
Depreciation	438	416	-	423	-	450	-
EBIT	3,408	3,104	9.8	3,757	(9.3)	3,597	-
Interest	3	6	-	1	-	5	-
Other Income	316	222	-	417	-	300	-
PBT	3,721	3,320	12.1	4,173	(10.8)	3,892	-
Less: Taxation	988	922	-	1,210	-	1,090	-
Less: Minority Interest	0	0	-	0	-	0	-
Recurring PAT	2,733	2,398	14.0	2,963	(7.8)	2,802	(2.5)
Exceptional items	(60)	266	-	(70)	-	0	-
Reported PAT	2,673	2,664	0.4	2,893	(7.6)	2,802	(4.6)
Key Ratios (%)							
Gross Margin	60.2	61.7	-	60.0	-	60.0	-
EBITDA Margin	33.7	35.4	-	33.3	-	34.8	-
Tax / PBT	26.5	27.8	-	29.0	-	28.0	-
NPM	24.0	24.1	-	23.6	-	24.1	-
EPS (Rs)	10.3	9.0	-	11.2	-	10.6	-

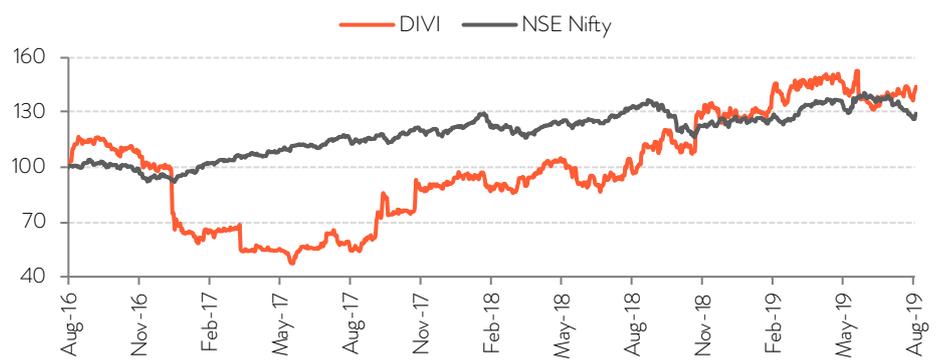
Source: Company, BOBCAPS Research

Valuation methodology

While we continue to like DIVI's solid execution, we believe a softer mid-term growth trajectory will weaken stock performance, at least in the medium term. The Q1 miss implies a steep ask for the remaining quarters given FY20 guidance of 10% revenue growth and 37-38% EBITDA margins. Management expects improvement in operational results in H2FY20 backed by an uptick in the CS mix and benefits of backward integration. We will be watchful of this. We maintain our FY20/FY21 EPS estimates of Rs 54/65 (Rs 10.3 in Q1). Rolling valuations forward, we have a revised Sep'20 target price of Rs 1,750 (from Rs 1,680).

Retain REDUCE considering (1) rich valuations – the stock is trading at 26x FY21E earnings vs. the three-year/five-year historical mean of 23-24x, (2) slow growth in FY20 off a high base – we expect 10-12% EPS growth, (3) backended capex benefits, and (4) limited scope for earnings upgrades. All this would keep stock performance weak in the medium term.

FIG 2 – 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	54,105	63,244	73,513
EBITDA	12,608	18,719	20,419	24,627	30,096
EBIT	11,184	17,030	18,598	22,329	27,687
Net interest income/(expenses)	(13)	(35)	(35)	(17)	(17)
Other income/(expenses)	855	1,247	1,213	1,386	1,438
Exceptional items	0	0	0	0	0
EBT	12,025	18,242	19,776	23,699	29,108
Income taxes	3,543	5,023	5,445	6,525	8,015
Extraordinary items	280	309	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	8,762	13,528	14,331	17,173	21,093
Adjustments	(280)	(309)	0	0	0
Adjusted net profit	8,482	13,219	14,331	17,173	21,093

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	4,112	4,922	4,807	5,431	5,949
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	68,966	74,493	85,315	98,607
Shareholders' fund	59,170	69,497	75,024	85,846	99,138
Total liabilities and equities	67,750	80,385	85,654	96,544	110,354
Cash and cash eq.	1,124	1,152	5,467	6,758	14,476
Accounts receivables	10,143	11,633	11,910	13,922	16,182
Inventories	13,506	17,723	17,080	19,965	23,207
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	85,654	96,544	110,354

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	10,186	15,217	16,152	19,471	23,503
Interest expenses	13	35	35	17	17
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(2,508)	(5,838)	462	(4,273)	(4,984)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	7,692	9,413	16,650	15,215	18,535
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)	(2,902)	(8,804)	(6,351)	(7,801)
Cash flow from financing	(2,269)	(2,512)	(8,839)	(6,924)	(7,817)
Changes in cash and cash eq.	338	32	4,311	1,291	7,717
Closing cash and cash eq.	1,124	1,156	5,467	6,758	14,476

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	33.0	51.0	54.0	64.7	79.4
Adjusted EPS	31.9	49.8	54.0	64.7	79.4
Dividend per share	12.0	18.8	20.0	23.9	29.4
Book value per share	222.9	261.8	282.6	323.3	373.4

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	10.9	8.5	7.8	6.6	5.7
EV/EBITDA	33.7	22.6	20.7	17.0	13.8
Adjusted P/E	52.1	33.4	30.8	25.7	21.0
P/BV	7.5	6.4	5.9	5.1	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	106.3	106.1	105.1
EBIT margin (EBIT/Revenue)	28.7	34.4	34.4	35.3	37.7
Asset turnover (Revenue/Avg TA)	15.0	16.7	16.3	17.4	17.8
Leverage (Avg TA/Avg Equity)	1.1	1.2	1.1	1.1	1.1
Adjusted ROAE	15.0	20.5	19.8	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	9.4	16.9	16.2
EBITDA	(15.1)	48.5	9.1	20.6	22.2
Adjusted EPS	(22.9)	55.8	8.4	19.8	22.8
Profitability & Return ratios (%)					
EBITDA margin	32.4	37.8	37.7	38.9	40.9
EBIT margin	28.7	34.4	34.4	35.3	37.7
Adjusted profit margin	21.8	26.7	26.5	27.2	28.7
Adjusted ROAE	15.0	20.5	19.8	21.4	22.8
ROCE	14.5	19.7	19.0	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	4.1	4.4	5.4
Net interest coverage ratio	840.9	486.6	531.4	1,347.4	1,670.7
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%

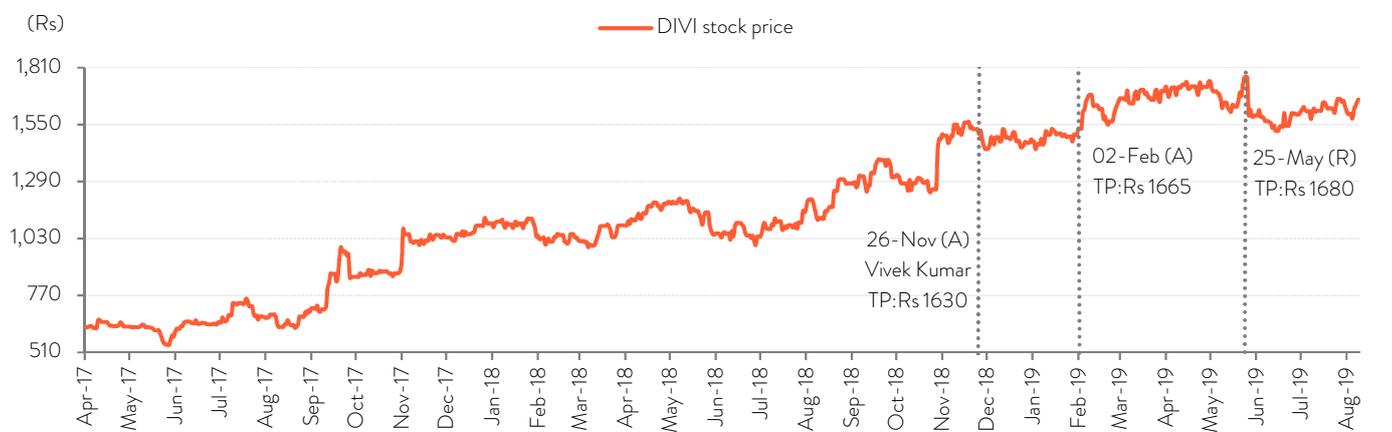
ADD – Expected return from >+5% to +15%

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

Rating distribution

As of 31 July 2019, out of 77 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 44 have BUY ratings, 16 are rated ADD, 8 are rated REDUCE and 9 are rated SELL. None of these companies have been investment banking clients in the last 12 months.

Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

General disclaimers

BOBCAPS is engaged in the business of Institutional Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance, wealth management and portfolio management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2020. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations

expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities — that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have “long” or “short” positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may act as market makers or assume an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company in the past 12 months. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.