

**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.**

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**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.

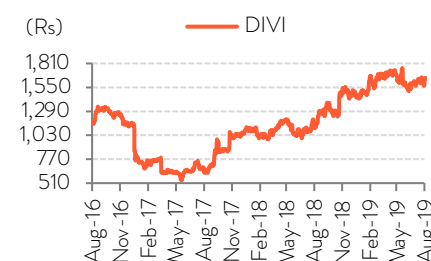
**Other Q1 highlights:** (1) FDA issued zero 483s for Unit-2 during the May'19 inspection. (2) Q1 forex loss was Rs 70mn. (3) Implementation of total capex of Rs 16.9bn is on track. (4) Q1 capitalisation was Rs 1.12bn – expected total capitalisation is at Rs 12bn in FY20 incl. CWIP. (5) Balance sheet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

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**FIG 1 – QUARTERLY PERFORMANCE**

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

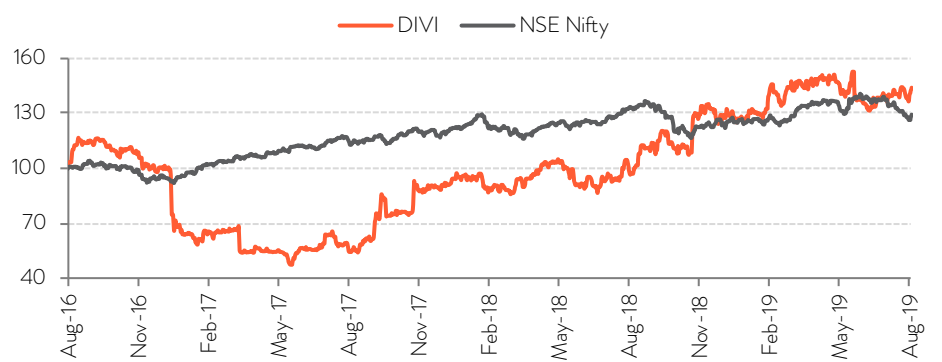
Source: Company, BOBCAPS Research

## 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
<b>Total revenue</b>	<b>38,906</b>	<b>49,462</b>	<b>54,105</b>	<b>63,244</b>	<b>73,513</b>
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
<b>Reported net profit</b>	<b>8,762</b>	<b>13,528</b>	<b>14,331</b>	<b>17,173</b>	<b>21,093</b>
Adjustments	(280)	(309)	0	0	0
<b>Adjusted net profit</b>	<b>8,482</b>	<b>13,219</b>	<b>14,331</b>	<b>17,173</b>	<b>21,093</b>

### 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
<b>Total liabilities and equities</b>	<b>67,750</b>	<b>80,385</b>	<b>85,654</b>	<b>96,544</b>	<b>110,354</b>
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
<b>Total assets</b>	<b>67,750</b>	<b>80,381</b>	<b>85,654</b>	<b>96,544</b>	<b>110,354</b>

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
<b>Cash flow from operations</b>	<b>7,692</b>	<b>9,413</b>	<b>16,650</b>	<b>15,215</b>	<b>18,535</b>
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
<b>Cash flow from investing</b>	<b>(5,085)</b>	<b>(6,870)</b>	<b>(3,500)</b>	<b>(7,000)</b>	<b>(3,000)</b>
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)
<b>Cash flow from financing</b>	<b>(2,269)</b>	<b>(2,512)</b>	<b>(8,839)</b>	<b>(6,924)</b>	<b>(7,817)</b>
<b>Changes in cash and cash eq.</b>	<b>338</b>	<b>32</b>	<b>4,311</b>	<b>1,291</b>	<b>7,717</b>
<b>Closing cash and cash eq.</b>	<b>1,124</b>	<b>1,156</b>	<b>5,467</b>	<b>6,758</b>	<b>14,476</b>

### 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
<b>YoY growth (%)</b>					
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
<b>Profitability &amp; Return ratios (%)</b>					
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
<b>Working capital days (days)</b>					
Receivables	90	80	80	80	80
Inventory	125	115	115	115	115
Payables	95	90	90	90	90
<b>Ratios (x)</b>					
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%

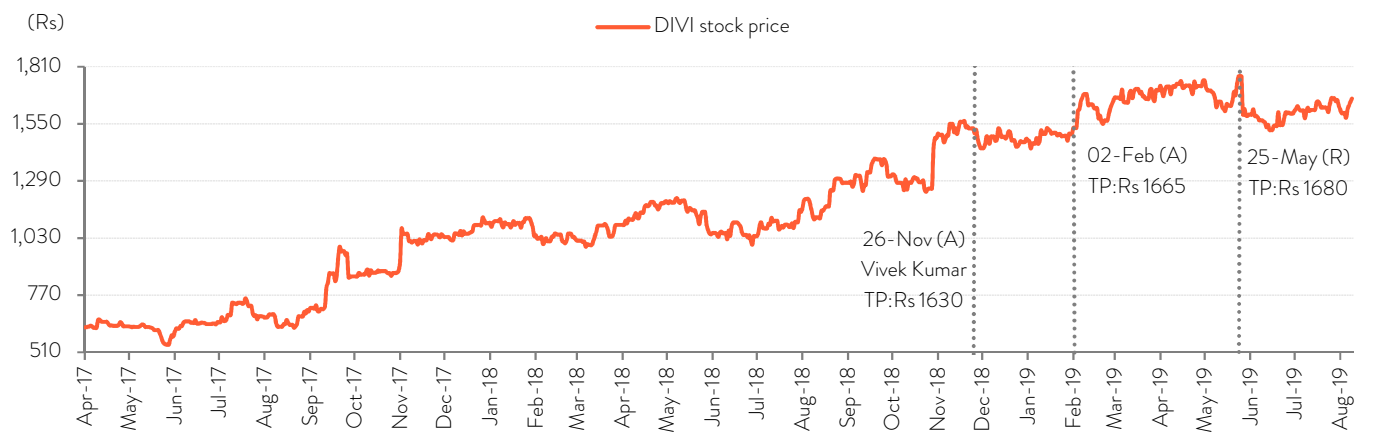
**ADD** – Expected return from >+5% to +15%

**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

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