

ADD

TP: Rs 2,180 | ▲ 11%

DIVI'S LABS

Pharmaceuticals

05 February 2020

Earnings miss but expect recovery from Q4

Divi's Labs (DIVI) reported a Q3FY20 revenue/EBITDA miss of 8-10% as multiple regulatory inspections restricted full production. The company expects normalcy to return from Q4. Gross margin at 60.6% was above estimates, reflecting benefits of backward integration (despite a flat CS mix QoQ at 41%). RM price has not risen due to the coronavirus impact in China so far, as per management. FY20 revenue growth guidance remains at 10%. Maintain ADD; on rollover, we have a Mar'21 TP of Rs 2,180 (vs. Rs 1,765).

Vivek Kumar

research@bobcaps.in

Q3 EBITDA miss, transient in nature: Operationally, Q3 witnessed benefits of backward integration in API, as reflected in the gross margin which came in at 60.6% (110bps higher than estimated and up 175bps QoQ). However, the 10% EBITDA miss was driven by lower revenues – this was due to a focus on compliance at Unit I (inspected in Nov'19) and Unit II (mid-Jan'20), leading to lower production. CS business was flat YoY with the sales mix flat QoQ at 41%. DIVI continues to add new customers in generic APIs (+7% YoY). Management retained its guidance of 10% revenue growth and 34-36% margins for FY20.

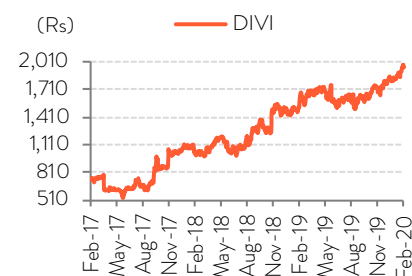
Earnings call highlights: (1) Q3 forex gain was Rs 179mn. (2) Implementation of total capex of Rs 16.9bn is on track. (2) Q3/9M capitalisation stood at Rs 200mn/Rs 2.25bn – expected total capitalisation is at Rs 12bn for FY20 incl. CWIP. (4) Nutraceutical sales rose 15% YoY to Rs 1.0bn in Q3. (5) Raw material shipment from other ports of China have not been impacted.

Retain ADD with TP of Rs 2,180: We maintain our FY20/FY21/FY22 EPS estimates of Rs 52/Rs 64/Rs 79 (9M EPS was Rs 36). While valuations appear expensive (trading at 25x FY22E EPS vs. the 3Y/5Y historical mean of 24x-26x), we believe the stock will see sustained positive momentum given DIVI's solid business model and ROCE profile.

Ticker/Price	DIVI IN/Rs 1,963
Market cap	US\$ 7.3bn
Shares o/s	266mn
3M ADV	US\$ 12.9mn
52wk high/low	Rs 2,022/Rs 1,466
Promoter/FPI/DII	52%/17%/17%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	38,906	49,462	54,713	63,852	74,121
EBITDA (Rs mn)	12,608	18,719	19,828	24,545	29,975
Adj. net profit (Rs mn)	8,482	13,219	13,902	17,104	20,988
Adj. EPS (Rs)	31.9	49.8	52.4	64.4	79.1
Adj. EPS growth (%)	(22.9)	55.8	5.2	23.0	22.7
Adj. ROAE (%)	15.0	20.6	19.3	21.4	22.8
Adj. P/E (x)	61.4	39.4	37.5	30.5	24.8
EV/EBITDA (x)	40.3	26.9	25.3	20.4	16.6

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)	Q3FY20	Q3FY19	YoY (%)	Q2FY20	QoQ (%)	Q3FY20E	Var (%)	9MFY20	9MFY19	YoY (%)
Net Sales	13,904	13,429	3.5	14,039	(1.0)	15,162	(8.3)	39,342	36,232	8.6
EBITDA	4,969	5,645	(12.0)	4,854	2.4	5,503	(9.7)	13,669	14,307	(4.5)
Depreciation	467	425	-	459	-	450	-	1,364	1,270	-
EBIT	4,502	5,220	(13.8)	4,395	2.4	5,053	-	12,305	13,037	(5.6)
Interest	16	25	-	38	-	5	-	57	34	-
Other Income	224	346	-	345	-	345	-	885	838	-
PBT	4,711	5,541	(15.0)	4,702	0.2	5,392	-	13,133	13,841	(5.1)
Less: Taxation	1,282	1,334	-	1,302	-	1,510	-	3,572	3,795	-
Less: Minority Interest	0	0	-	0	-	0	-	0	0	-
Recurring PAT	3,429	4,207	(18.5)	3,400	0.8	3,883	(11.7)	9,561	10,046	(4.8)
Exceptional items	179	(411)	-	129	-	0	-	248	385	-
Reported PAT	3,608	3,796	(5.0)	3,529	2.2	3,883	(7.1)	9,810	10,431	(6.0)
Key Ratios (%)										
Gross Margin	60.6	64.2	-	58.9	-	59.5	-	59.9	63.2	-
EBITDA Margin	35.7	42.0	-	34.6	-	36.3	-	34.7	39.5	-
Tax / PBT	27.2	24.1	-	27.7	-	28.0	-	27.2	27.4	-
NPM	24.7	31.3	-	24.2	-	25.6	-	24.3	27.7	-
EPS (Rs)	12.9	15.8	-	12.8	-	14.6	-	36.0	37.8	-

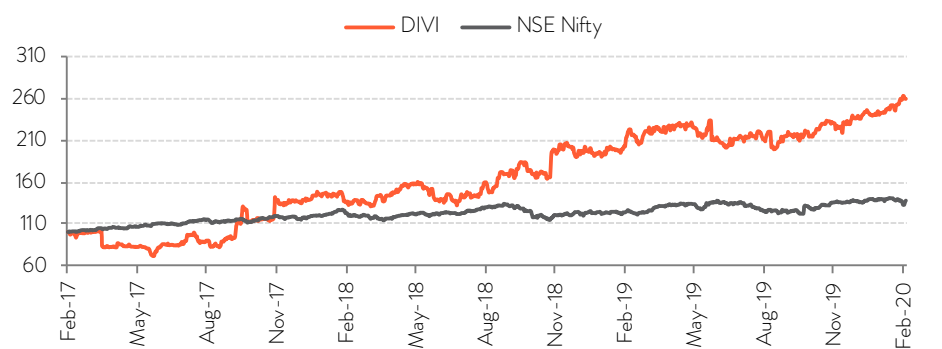
Source: Company, BOBCAPS Research

Valuation methodology

We continue to like DIVI’s solid execution (across chemistry skills), cost edge, strong balance sheet and robust cash flows, and believe upcoming quarters should see positive improvement in margin trajectory. Also, a lack of alternatives among large-cap generic peers, which continue to struggle on the ROCE matrix, would continue driving an upward bias in the stock even though valuations are expensive. We expect better earnings growth for FY21/FY22 at over 23%.

The stock is trading at 25x FY22E earnings vs. the three-year/five-year historical mean of 24-26x. We maintain our FY20/FY21/FY22 EPS estimates of Rs 52/ Rs 64/Rs 79. Rolling valuations forward and increasing our target EV/EBITDA multiple to 19x (from 17x), we have a revised Mar’21 target price of Rs 2,180 (from Rs 1,765). Retain ADD.

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	54,713	63,852	74,121
EBITDA	12,608	18,719	19,828	24,545	29,975
Depreciation	1,424	1,689	1,822	2,298	2,410
EBIT	11,184	17,030	18,006	22,247	27,565
Net interest income/(expenses)	(13)	(35)	(35)	(17)	(17)
Other income/(expenses)	855	1,247	1,213	1,373	1,414
Exceptional items	0	0	0	0	0
EBT	12,025	18,242	19,185	23,603	28,963
Income taxes	3,543	5,023	5,283	6,499	7,975
Extraordinary items	280	309	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	8,762	13,528	13,902	17,104	20,988
Adjustments	(280)	(309)	0	0	0
Adjusted net profit	8,482	13,219	13,902	17,104	20,988

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	4,112	4,922	5,132	5,562	6,090
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	68,943	74,176	84,925	98,115
Shareholders' fund	59,170	69,474	74,707	85,456	98,646
Total liabilities and equities	67,750	80,362	85,662	96,285	110,003
Cash and cash eq.	1,124	1,152	5,149	6,174	13,798
Accounts receivables	10,143	11,633	12,044	14,056	16,316
Inventories	13,506	17,723	17,272	20,157	23,399
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	85,662	96,285	110,003

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	10,186	15,217	15,724	19,402	23,398
Interest expenses	13	35	35	17	17
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(2,508)	(5,838)	462	(4,466)	(4,975)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	7,692	9,413	16,220	14,953	18,439
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)	(2,926)	(8,669)	(6,355)	(7,798)
Cash flow from financing	(2,269)	(2,536)	(8,704)	(6,928)	(7,815)
Changes in cash and cash eq.	338	8	4,016	1,025	7,625
Closing cash and cash eq.	1,124	1,132	5,149	6,174	13,798

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	33.0	51.0	52.4	64.4	79.1
Adjusted EPS	31.9	49.8	52.4	64.4	79.1
Dividend per share	12.0	18.9	19.5	23.9	29.4
Book value per share	222.9	261.7	281.4	321.9	371.5

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	13.1	10.2	9.2	7.8	6.7
EV/EBITDA	40.3	26.9	25.3	20.4	16.6
Adjusted P/E	61.4	39.4	37.5	30.5	24.8
P/BV	8.8	7.5	7.0	6.1	5.3

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	106.5	106.1	105.1
EBIT margin (EBIT/Revenue)	28.7	34.4	32.9	34.8	37.2
Asset turnover (Revenue/Avg TA)	15.0	16.7	16.5	17.5	18.0
Leverage (Avg TA/Avg Equity)	1.1	1.2	1.2	1.1	1.1
Adjusted ROAE	15.0	20.6	19.3	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	10.6	16.7	16.1
EBITDA	(15.1)	48.5	5.9	23.8	22.1
Adjusted EPS	(22.9)	55.8	5.2	23.0	22.7
Profitability & Return ratios (%)					
EBITDA margin	32.4	37.8	36.2	38.4	40.4
EBIT margin	28.7	34.4	32.9	34.8	37.2
Adjusted profit margin	21.8	26.7	25.4	26.8	28.3
Adjusted ROAE	15.0	20.6	19.3	21.4	22.8
ROCE	14.5	19.7	18.5	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	3.9	4.3	5.3
Net interest coverage ratio	840.9	486.6	514.5	1,342.4	1,663.4
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%

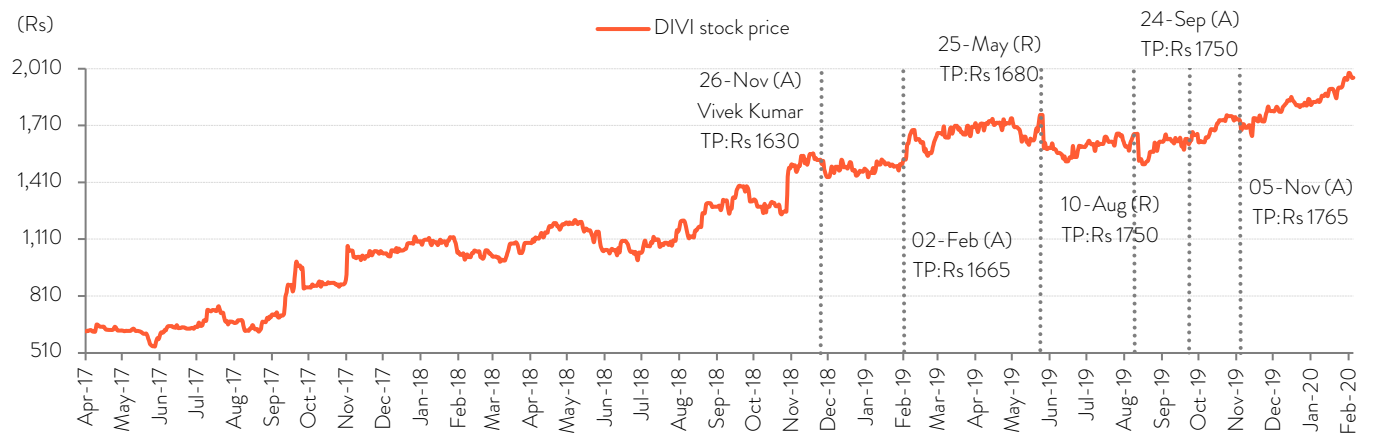
ADD – Expected return from >+5% to +15%

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 January 2020, out of 85 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 50 have BUY ratings, 18 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 and wealth 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.