Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Divis Laboratories Ltd

Worst is over; Upgrade to Buy

Pharmaceuticals	Sharekhan code: DIVISLAB

Reco/View: Buy ↑	CMP: Rs. 3,182	Price Target: Rs. 3,600 ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX	+	=	-
Right Sector (RS)		✓	
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↓	
RQ		↑	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING	17.8
Updated Apr 21, 2023	

Low Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

Company details

Market cap:	Rs. 84,534 cr
52-week high/low:	Rs. 4,439/2,730
NSE volume: (No of shares)	8.3 lakh
BSE code:	532488
NSE code:	DIVISLAB
Free float: (No of shares)	12.8 cr

Shareholding (%)

Promoters	51.9
FII	14.7
DII	21.1
Others	12.3

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-1.4	9.1	-3.6	-26.1
Relative to Sensex	-5.3	5.3	-4.5	-40.1

Sharekhan Research, Bloomberg

Summary

- We upgrade our Hold rating on Divis Laboratories (Divis) to Buy with a revised PT of Rs 3,600. The stock has corrected by ~21% over the last year and trades at ~38.6x and ~34.2x its FY2024/25E earnings versus peers that are trading at ~21x/17.1x its FY24/FY25 EPS estimates. It deserves premium valuations, as it clocks superior return ratios as compared to peers.
- Q4FY23 was largely in line on the profit front as unfavourable conditions such as operating de-leveraging seen due to fall in custom synthesis segment's revenues and core API as pricing pressures were factored in.
- Company has invested heavily in existing and new generic molecules' capacity expansion, backward integration, and custom synthesis segment. Another ~Rs. 1200-1,500 crore are slated to be invested in Kakinada III unit, is likely to be commissioned by ~FY26-FY27.
- Margins are expected to continue to lag behind historical averages and normalise by ~FY26-27, as incremental sales come in from new generic and custom synthesis and contrast media APIs.

Divis Labs reported in-line results for Q4FY23 on the profit front. In Q4FY23, revenues declined ~22.5% y-o-y (up 14.2% q-o-q) to Rs. 1,951 crore (vs. the internal estimate of Rs. 1,765 crore and consensus estimate of Rs. 1,792 crore) this was driven by a ~6.3% y-o-y/~12.0% q-o-q rise in generic APIs sales (~59.0% of revenue) and ~44.3% y-o-y decline and ~17% q-o-q rise in custom synthesis revenue (~41.0% of revenue) in Q4FY23. The gross profits fell ~33.1% y-o-y to Rs. 1,123 crore and gross margins declined ~912.0 bps y-o-y to ~57.6% in Q4FY23. EBITDA declined ~ 55.9% y-o-y to Rs. 488 crore (versus the internal estimate of Rs. 476 crore and consensus estimate of Rs. 477 Cr.) This was due to ~1.9% points decline in EBITDA margins to ~25.0% (versus internal estimate of ~27.0% and consensus estimate of ~26.6%) Net profits declined ~64.1% y-o-y (+4.6% q-o-q) to Rs. 321 Cr (vs. internal estimate of Rs. 344 Cr and consensus estimate of Rs. 347 crore.) The company perceives Custom synthesis opportunities for contrast media and Sartans besides commercial production of molecules going off patent between FY23-FY25 to be the growth engines in the next 3 years. However, pricing pressure in core APIs besides entry into new generic off patent molecules' production which is anticipated to commercialise in short to medium term may pose a challenge to the likelihood of reaching near historical profitability over the next two years; partially offset by softening of raw materials costs trend. We anticipate it to get back to pre-COVID EBITDA margins levels in the medium term.

Key positives

- OPM decreased by ~1.9% points y-o-y to ~25.0%
- Reported PAT declined by ~64.1% y-o-y to Rs. 321 crore.

Key negatives

- OPM improved by ~109 basis points q-o-q to ~25%
- Reported PAT increased by ~4.6% q-o-q to Rs. 321 crore.
- Commercial supply of Sartan and contrast media custom synthesized APIs has begun.

Management Commentary

- Greater opportunities and demand for generic APIs in segments such as contrast media, Sartans, and products about to go off-patent bring fresh growth opportunities over the next 3 years. Additionally, the custom synthesis project in collaboration with Big Pharma for contrast media production is progressing well and commercial manufacturing has started.
- Construction activity on the 500 acres of land is progressing well at a capex of Rs. 1,200-1,500 Cr for phase I development.
- It expects to grow at double-digit rate in the future.
- Raw material prices are reducing and stabilizing and to benefit in the coming quarters. Intends to get back to historical gross profits margins and expects it to be achieved by the end of ~FY24.

Revision in estimates: Given the commercialisation of Sartan, Contrast Media opportunities for custom synthesis and softening of raw material costs trends and the guidance of the management to get back to historical levels of profitability in the near term, we anticipate ~11.0% and ~16.0% CAGR rise in revenue and net income over FY23-FY25E, respectively.

Our Call

Valuation – Upgrade to Buy with a revised PT of Rs. 3,600: The company perceives custom synthesis opportunities for contrast media and Sartans besides commercial production of molecules going off patent between FY23-FY25E to be the growth engines over the next 3 years. However, pricing pressure in core APIs besides entry into new generic and off-patent molecules' production, which is anticipated to commercialise in short to medium term may pose a challenge to the likelihood of reaching peak historical profitability over the next two years; partially and favourably offset by softening of raw material costs trend. We anticipate it to get back to pre – COVID EBITDA margins over medium term. We upgrade our Hold rating on Divis Laboratories (Divis) to Buy with a revised PT of Rs 3,600. The stock has corrected by ~21.0% in the last year; however, it continues to trade at higher levels of ~38.6x and ~34.2x its FY2024/25E earning vs. its peers trading at ~21.0x/17.1x its FY24/FY25 EPS estimates. It deserves premium valuation, as it makes superior return ratios compared to peers. The company has delivered on the timelines with respect to commercialization of new orders with respect to Sartans and Contrast Media.

Key Risks

1) Adverse regulatory changes; 2) Unfavorable forex movements.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23	FY24E	FY25E
Net sales	6,969.40	8,959.83	7,767.51	8,343.40	9,511.47
OPM (%)	41.04	43.33	30.48	35.53	36.21
PAT	1,984.29	2,960.45	1,823.38	2,187.95	2,473.46
EPS (Rs)	74.75	111.52	68.69	82.42	93.18
PER (x)	42.57	28.53	46.33	38.61	34.15
EV/Ebidta (x)	28.78	21.21	34.77	27.77	23.90
ROCE (%)	28.02	30.44	15.85	17.58	17.58
RONW (%)	21.35	25.24	14.28	14.63	14.19

Source: Company; Sharekhan estimates

Q4: in line performance

Divis' Labs reported in line results for Q4FY23 on profits front. In Q4FY23 the revenue declined ~22.5% y-o-y (+14.2% q-o-q) to Rs. 1,951 Cr. (vs. internal estimate of Rs. 1,765 Cr and consensus estimate of Rs. 1,792 Cr) this was driven by ~6.3% y-o-y/~12.0% q-o-q rise in generic APIs sales (~59.0% of revenue) and ~44.3% y-o-y decline and ~17.0% q-o-q rise in custom synthesis revenue (~41.0% of revenue) in Q4FY23. The gross profits fell ~33.1% y-o-y to Rs. 1,123 Cr and gross profits margins declined ~912.0 bps y-o-y to ~57.6% in Q4FY23. EBITDA declined ~ 55.9% y-o-y to Rs. 488 Cr. (vs. internal estimate of Rs. 476 Cr and consensus estimate of Rs. 477 Cr.) This was due to ~1.9% points decline in EBITDA margins to ~25.0% (vs. internal estimate of ~27.0% and consensus estimate of ~26.6%) Net profits declined ~64.1% y-o-y to Rs. 321 Cr (vs. internal estimate of Rs. 344 Cr and consensus estimate of Rs. 347 Cr.) The custom synthesis project in collaboration with a big pharma company for contrast media production is progressing well and commercial manufacturing has started. Sartan products for custom synthesis has gone into commercial production and supply and will add to results of the coming quarters. Qualifications for the second product for custom synthesis is complete and a ramp up is happening for supplying it and is likely to reflect from coming quarters in the results. The company perceives Custom synthesis opportunities for contrast media and Sartans besides commercial production of molecules going off patent between FY23-FY25 to be the growth engines over the next 3 years. However, pricing pressure in core APIs besides entry into new generic off patent molecules' production which is anticipated to commercialise in short – medium term may pose a challenge to the likelihood of reaching near peak historical profitability over medium term.

Results (Consolidated) **Rs cr**

Particulars	Q4FY23	Q4FY22	YoY(%)	Q3FY23	QoQ(%)
Net revenues	1,951	2,518	-22.5	1,708	14.2
RM Cost	828	839	-1.3	740	11.9
Gross Profits	1,123	1,680	-33.1	968	16.0
Total operating expenditure	1,463	1,414	3.5	1,299	12.6
EBITDA	488	1,104	-55.9	408	19.4
Depreciation	87	81	7.4	87	0.3
EBIT	401	1,023	-60.9	322	24.6
Interest	0	0	200.0	0	84.6
Other Income	66	21	211.6	114	-42.1
PBT	466	1,045	-55.3	436	7.1
Tax Expense	146	181	-19.7	129	12.9
Adj.PAT	321	863	-62.8	307	4.6
Exceptional item	0	-31	NM	0	NM
Net PAT	321	895	-64.1	307	4.6
Margins(%)			**BPS**		
GPM	57.6	66.7	-912	56.7	88.40
EBITDA margin	25.0	43.9	-1886	23.9	108.63
APATM	16.5	34.3	-1783	18.0	-151.24
Net Profit margin	16.5	35.5	-1907	18.0	-151.24
Tax rate	31.2	17.3	1386	29.6	161.99

Source: Company, Sharekhan Research

Key conference call highlights

- **Fresh growth drivers:** The company capitalized on new opportunities to fuel growth and witnessing a gradual return to normalcy in core API product portfolio. The company is following its six-point strategic approach to unlock further growth opportunities. Increased opportunities and demand for generic API in segments such as contrast media, Sartans and products about to go off-patent bring new growth opportunities over the next 3 years. Additionally, the custom synthesis project in collaboration with big pharma for contrast media production is progressing well and commercial manufacturing has started.
- **Capital investment plans:** FY23 has been a significant year for Divi's Labs with all clearances for it obtained for its Unit-3 facility near Kakinada. Construction activity on the 500 acres of land is progressing well at a capex of Rs. 1,200 – Rs. 1,500 Cr for phase I development. The company expects to drive sustainable growth

through investments in new technologies, capacity expansion, and diversification of products portfolio to meet the requirements of emerging pipeline and continue to maintain the leadership position in the core products portfolio with implementation of green chemistry principle. Green chemistry usage is a must as it is viewed favorably by the global pharma clients. And hence the company is investing in Kakinada Unit 3 on a fast-track basis, since April 23 at a cost of Rs. 1,200-1,500 crore.

- **Guidance:**
  - **Sales growth:** Expects to grow at double digit rate in the future.
  - **Capacity utilisation:** For FY24 the company intends to focus on maximizing capacity utilization. Additional capacities are in qualification for generic products with existing clients and should drive growth. For one of the big pharma companies for contrast media validations are complete and commercial production has started, so in the coming quarters, the growth is likely to be driven by it. The company intends to be a leader in the new generic products as well like in existing generic API products. Fixed growth engine for the company is a $20 billion opportunity, which is being made available between FY23-FY25 post the patent expiry for the products and the focus will continue to be on APIs. Sartan products for custom synthesis has gone into commercial production and supply and will add to results of the coming quarters. Qualifications for the second product for custom synthesis is complete and a ramp-up is happening for supplying it and is likely to reflect from coming quarters in the results. With excess supply of generic formulations, the generic API demand is low but expects the pricing scenario to improve in the coming quarters.
  - **Raw materials costs:** Raw material prices are reducing and stabilizing and to benefit in the coming quarters. Intends to get back to historical gross profits margins and expects it to be achieved by the end of ~FY24. Sea and air freight rates improved during Q4FY23. The company has achieved stability in raw material procurements and availability leading to marginal softening in raw materials costs q-o-q. As the company has diversified its supply base domestically its dependence on China has reduced y-o-y. The company is diversifying its supply base to maintain its leadership position in core products.
  - **Product mix:** The company would like to maintain ~50:50 ratio for generic and custom synthesis but ~60:40 ratio either of the way is most likely over a period of time. The one-time anti-COVID-19 drug opportunity gave a push to sales and now there is no requirement for it. But other products are there where the company is entering in besides softening of raw materials costs should help it, going forward. Around 6-9 months of inventory was maintained instead of a regular ~3 months of inventory that is also causing unfavorable changes to gross profits margins. Going forward expects normalcy in it by the end of the year.
- **Financial performance:**
  - Total income, including other non-operating income was Rs. 2,017 Cr. for Q4FY23 vs. Rs. 2,571 crore in Q4FY22.
  - Materials consumption came at around ~42% of sales due to change in products mix. PBT was Rs. 466 Cr. and PAT was Rs. 321 crore for Q4FY23
  - Exports were at ~90% of sales and exports to Europe and the US were at ~68.0% of sales in Q4FY23 and ~ 70% for FY23.
  - For FY23 generic versus custom synthesis mix was at ~56% and ~44% and ~59.0% and ~41% for the quarter.
  - Forex loss was Rs. 4 crore for Q4FY23 and forex gain of Rs. 130 Cr for FY23
  - Constant currency growth has been negative at -32% in Q4FY23 -21.0% for FY23.
  - Nutraceutical business amounted to ~Rs. 160 crore and ~Rs. 660 crore for FY23
  - Capitalized assets worth ~Rs. 480 crore in Q4FY23 and ~Rs. 745 crore for FY23.
  - Capital work in Progress was ~Rs. 212 crore at the end of Q4FY23
  - Cash on books stood at ~Rs. 4,136 crore as of Q4FY23

Outlook and Valuation

■ Sector view - Regulatory concerns and pricing erosion prove a hurdle over the short-medium term

Over the years, Indian pharmaceutical companies have established themselves as a dependable source for global pharma companies. A confluence of other factors, including a focus on specialty/complex products in addition to emerging opportunities in the API space, would be key growth drivers over the long term. However, ongoing USFDA plant inspections and a few companies being issued Form 483 with observations point at apparent regulatory concerns. We believe in the near term, based on the headwinds that may drag the performance, especially in the API and CDMO space and for large pharma players seeing USFDA OAI or WL status on their facilities, we have a Neutral view of the sector.

■ Company outlook - Earnings prospects weaken in the short to medium term

Divis' long-term growth opportunities are robust, and the company is well-placed to capitalize on the same. Similarly, growth levers in the generic API space are also promising over the long term, though concerns in the near term could drag growth. The hunt by global companies for alternative procurement sources for API/ intermediates drugs is expected to benefit API-centric players such as Divis. New areas of contrast media manufacturing and focus on molecules going off patent in the next two years offering an addressable market size of $20 bn, could fuel the growth going ahead. Consequently, the company has completed a substantial capacity expansion plan across its facilities for both the API as well as custom synthesis business. With expanded capacities going on stream, Divis could be best placed to cater to increased demand. Moreover, the company has entered the contract media manufacturing space recently, which is growing annually by 10-15%. With a substantial global addressable market size of $4-6 billion, this space has the potential to provide considerable growth opportunities. Moreover, the management has defined its six pillars or focus areas, which are expected to propel the company's growth in the times to come. Escalating costs with fall in revenues, however, it could lead to margin pressures in the near term, though backward integration and expanded capacities could be the long-term levers.

■ Valuation - Upgrade to Buy with a revised PT of Rs. 3,600

The company perceives custom synthesis opportunities for contrast media and Sartans besides commercial production of molecules going off patent between FY23-FY25E to be the growth engines over the next 3 years. However, pricing pressure in core APIs besides entry into new generic and off-patent molecules' production, which is anticipated to commercialise in short to medium term may pose a challenge to the likelihood of reaching peak historical profitability over the next two years; partially and favourably offset by softening of raw material costs trend. We anticipate it to get back to pre – COVID EBITDA margins over medium term. We upgrade our Hold rating on Divis Laboratories (Divis) to Buy with a revised PT of Rs 3,600. The stock has corrected by ~21.0% in the last year; however, it continues to trade at higher levels of ~38.6x and ~34.2x its FY2024/25E earning vs. its peers trading at ~21.0x/17.1x its FY24/FY25 EPS estimates. It deserves premium valuation, as it makes superior return ratios compared to peers. The company has delivered on the timelines with respect to commercialization of new orders with respect to Sartans and Contrast Media.

Peer Comparison

Companies	CMP (Rs / Share)	O/S Shares (Crs)	MCAP (Rs Cr)	P/E (x)			EV / EBITDA (x)			RoE (%)		
				FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Laurus Labs	313.8	53.7	16,860	21.4	25.4	18.1	11.9	13.4	10.7	19.6	14.2	16.6
Divis Laboratories	3,182.0	26.5	84,472	46.3	38.6	34.1	34.8	27.8	23.9	14.3	14.6	14.2

Source: Company; Sharekhan Research

About company

Divis, based in Hyderabad, India, has two manufacturing units and is among the top pharmaceutical companies in India. Divis is the leading manufacturer of APIs, intermediates, and registered starting materials offering high-quality products with the highest level of compliance and integrity to over 95 countries. Advanced manufacturing facilities, both in Hyderabad and Vizag, have been inspected multiple times by USFDA, EU GMP (U.K., Slovenia, German, and Irish authorities), HEALTH CANADA, TGA, ANVISA, COFEPRIS, PMDA, and MFDS health authorities.

Investment theme

Divis' long-term growth opportunities are intact and the company is well placed to capitalize on the same. Immense opportunities lie ahead in the contract research and manufacturing space (CRAMS). Similarly, growth levers in the generic API space are promising. With expanded capacities having been ready while new product opportunties are yet to fully commercialise fully untill FY2025, Divis business' prosepcts weaken over short – medium term.

Key Risks

1) Adverse regulatory change

2) Regulatory compliance risk

3) Forex volatility

Additional Data

Key management personnel

Dr. Murali K. Divi	Managing Director
Mr. Kishore Babu	CFO
Dr. Kiran S. Divi	Whole time Director and CEO

Source: Company

Top shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management	6.70
2	Life Insurance Corp India	5.53
3	Axis Asset Management	3.06
4	Government Pension Fund Global	1.20

Source: BSE

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Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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