

# Divi's Laboratories (DIVI IN)

## Growth outlook remains muted

### INDIA | PHARMACEUTICALS | Company Update

27 March 2017

Divi's received an import alert (IA) for its Unit 2 facility at Vizag, Andhra Pradesh, from the USFDA last week, based on inspections conducted in December 2016. However, 10 products, including Levetiracetam, Gabapentin, Lamotrigine, Capecitabine, Naproxen sodium, Raltegravir potassium, Atovaquone, 26U90 (chloropurine), BOC core succinate, and 2,4-wing active ester, are exempted from IA. Nonetheless, in order to provide more clarity about the USFDA's import alert on its Unit 2 and its impact on future business, the management organised a conference call today. Following are the key highlights: -

#### Conference call takeaways

- US exposure (including indirect supplies) of Divi's Unit 2 is around 22%, but the drug exemptions protect most of the US sales of the unit. Considering the exemptions, Divi's management expects a net revenue impact of 3-5%. Additionally, its customers are trying for more product exemptions from the IA.
- Since the company received an IA before a warning letter, it has already started corrective and preventive actions (CAPA) based on observations in the Form 483, has provided an update on its CAPA in January 2017, and is ready to file a 2<sup>nd</sup> update on CAPA by 31st March 2017. However, the management is waiting for a detailed communication from the USFDA on IA, based on which Divi's will plan remediation action.
- Management expects limited remediation cost at Unit 2, as it believes observations are procedural and do not require major changes in plant/equipment.
- The USFDA has already given a methodology for the export of exempted products to the US; accordingly, DIVI is in discussions with a third party for verifying its operations.
- DIVI expects no impact of the IA on its capacity expansions (Rs 2.5bn brownfield expansion in Vizag and Rs 5bn greenfield expansion in Kakinada). In order to manage capacity constraints and delay in planned expansions, it is expanding Unit 1 capacity with an investment of Rs 1.75bn.
- It indicated that its Unit 1 was inspected by the USFDA in June 2014 and a routine inspection is possible anytime. It says it is well prepared as it has already corrected issues in Unit 1 as per observations highlighted in Unit 2.
- Divi's has a current cash position of ~Rs 17bn but it does not have a buyback or special dividend plan soon; its prime focus will be on resolving plant-related issues.
- Expects moderate growth of 10% in sales over the next two years due to capacity constraints, delay in greenfield projects, and the impact of the IA.

#### Reiterate our Neutral stance with TP of Rs 690

The management comments are almost in line with our expectations. We continue to factor: –(1) batch-by-batch verification of US exports of exempted products by a third party, (2) potential cancellation of supply contracts by customers, mainly in generic APIs, and (3) incremental remediation cost would have a toll on profitability in the near future. The resolution of the plant issue could take about two years. Factoring these concerns, we estimate sales/earnings CAGR of +2%/-5% over FY17-19.

We value DIVI at Rs 690, i.e., 17x our FY19 EPS, implying an upside of 11%. The ongoing regulatory issues loom over DIVI and the stock has already corrected 44% since the Form 483 in November 2016. We reiterate our Neutral rating with a TP of Rs 690.

## NEUTRAL (Maintain)

CMP RS 623

TARGET RS 690 (+11%)

#### COMPANY DATA

|                        |            |
|------------------------|------------|
| O/S SHARES (MN) :      | 265        |
| MARKET CAP (RSBN) :    | 202        |
| MARKET CAP (USDBN) :   | 3.1        |
| 52 - WK HI/LO (RS) :   | 1380 / 672 |
| LIQUIDITY 3M (USDMN) : | 31.6       |
| PAR VALUE (RS) :       | 2          |

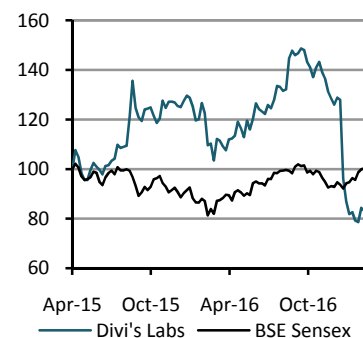
#### SHARE HOLDING PATTERN, %

|                   | Dec 16 | Sep 16 | Jun 16 |
|-------------------|--------|--------|--------|
| PROMOTERS :       | 52.1   | 52.1   | 52.1   |
| FII / NRI :       | 19.8   | 20.9   | 19.8   |
| FI / MF :         | 14.6   | 13.5   | 14.2   |
| NON PRO :         | 2.3    | 2.3    | 2.2    |
| PUBLIC & OTHERS : | 11.2   | 11.2   | 11.7   |

#### PRICE PERFORMANCE, %

|            | 1MTH | 3MTH  | 1YR   |
|------------|------|-------|-------|
| ABS        | 2.0  | -33.8 | -21.7 |
| REL TO BSE | -2.2 | -45.8 | -41.9 |

#### PRICE VS. SENSEX



Source: Phillip Capital India Research

#### KEY FINANCIALS

| Rs mn           | FY17E  | FY18E  | FY19E  |
|-----------------|--------|--------|--------|
| Net Sales       | 44,131 | 41,444 | 45,488 |
| EBIDTA          | 16,117 | 13,791 | 15,416 |
| Net Profit      | 11,870 | 9,584  | 10,766 |
| EPS, Rs         | 44.7   | 36.1   | 40.6   |
| PER, x          | 13.9   | 17.3   | 15.4   |
| EV/EBIDTA, x    | 10.2   | 12.0   | 10.4   |
| P/BV, x         | 3.2    | 2.9    | 2.5    |
| ROE, %          | 23.0   | 16.5   | 16.4   |
| Debt/Equity (%) | 1.3    | 1.1    | 1.0    |

Source: PhillipCapital India Research Est.

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## Financials

### Income Statement

| Y/E Mar, Rs mn               | FY16          | FY17E         | FY18E         | FY19E         |
|------------------------------|---------------|---------------|---------------|---------------|
| <b>Net sales</b>             | <b>37,764</b> | <b>44,131</b> | <b>41,444</b> | <b>45,488</b> |
| Growth, %                    | 21            | 17            | -6            | 10            |
| Total income                 | 37,764        | 44,131        | 41,444        | 45,488        |
| Raw material expenses        | -15,053       | -17,343       | -16,578       | -18,104       |
| Employee expenses            | -3,649        | -4,890        | -4,476        | -4,822        |
| Other Operating expenses     | -4,924        | -5,781        | -6,600        | -7,146        |
| <b>EBITDA (Core)</b>         | <b>14,138</b> | <b>16,117</b> | <b>13,791</b> | <b>15,416</b> |
| Growth, %                    | 21.3          | 14.0          | (14.4)        | 11.8          |
| Margin, %                    | 37.4          | 36.5          | 33.3          | 33.9          |
| Depreciation                 | -1,182        | -1,390        | -1,635        | -1,803        |
| <b>EBIT</b>                  | <b>12,956</b> | <b>14,726</b> | <b>12,155</b> | <b>13,613</b> |
| Growth, %                    | 25.9          | 13.7          | (17.5)        | 12.0          |
| Margin, %                    | 34.3          | 33.4          | 29.3          | 29.9          |
| Interest paid                | -23           | -13           | -12           | -14           |
| Other Non-Operating Income   | 604           | 702           | 809           | 949           |
| <b>Pre-tax profit</b>        | <b>13,781</b> | <b>15,415</b> | <b>12,952</b> | <b>14,548</b> |
| Tax provided                 | -2,662        | -3,546        | -3,367        | -3,783        |
| <b>Profit after tax</b>      | <b>11,118</b> | <b>11,870</b> | <b>9,584</b>  | <b>10,766</b> |
| <b>Net Profit</b>            | <b>11,118</b> | <b>11,870</b> | <b>9,584</b>  | <b>10,766</b> |
| Growth, %                    | 26.1          | 9.2           | (19.3)        | 12.3          |
| <b>Net Profit (adjusted)</b> | <b>10,874</b> | <b>11,870</b> | <b>9,584</b>  | <b>10,766</b> |
| Unadj. shares (m)            | 265           | 265           | 265           | 265           |
| Wtd avg shares (m)           | 265           | 265           | 265           | 265           |

### Balance Sheet

| Y/E Mar, Rs mn                        | FY16          | FY17E         | FY18E         | FY19E         |
|---------------------------------------|---------------|---------------|---------------|---------------|
| Cash & bank                           | 717           | 1,229         | 877           | 5,107         |
| Debtors                               | 8,809         | 10,542        | 10,016        | 10,993        |
| Inventory                             | 12,078        | 14,785        | 14,595        | 15,871        |
| Loans & advances                      | 2,932         | 3,354         | 3,564         | 3,912         |
| Other current assets                  | 54            | 92            | 93            | 93            |
| Total current assets                  | 24,591        | 30,003        | 29,145        | 35,977        |
| Investments                           | 8,025         | 10,025        | 12,025        | 14,025        |
| Gross fixed assets                    | 21,961        | 25,278        | 30,284        | 33,390        |
| Less: Depreciation                    | -7,573        | -8,963        | -10,599       | -12,402       |
| Add: Capital WIP                      | 2,639         | 3,000         | 4,500         | 2,500         |
| Net fixed assets                      | 17,027        | 19,315        | 24,185        | 23,488        |
| <b>Total assets</b>                   | <b>49,643</b> | <b>59,343</b> | <b>65,355</b> | <b>73,490</b> |
| Current liabilities                   | 4,727         | 5,516         | 5,181         | 5,686         |
| Provisions                            | 164           | 164           | 164           | 164           |
| Total current liabilities             | 4,891         | 5,680         | 5,344         | 5,850         |
| Non-current liabilities               | 1,875         | 2,113         | 2,073         | 2,134         |
| Total liabilities                     | 6,766         | 7,793         | 7,418         | 7,984         |
| Paid-up capital                       | 531           | 531           | 531           | 531           |
| Reserves & surplus                    | 42,346        | 51,021        | 57,408        | 64,976        |
| Shareholders' equity                  | 42,877        | 51,552        | 57,939        | 65,507        |
| <b>Total equity &amp; liabilities</b> | <b>49,643</b> | <b>59,343</b> | <b>65,355</b> | <b>73,490</b> |

### Cash Flow

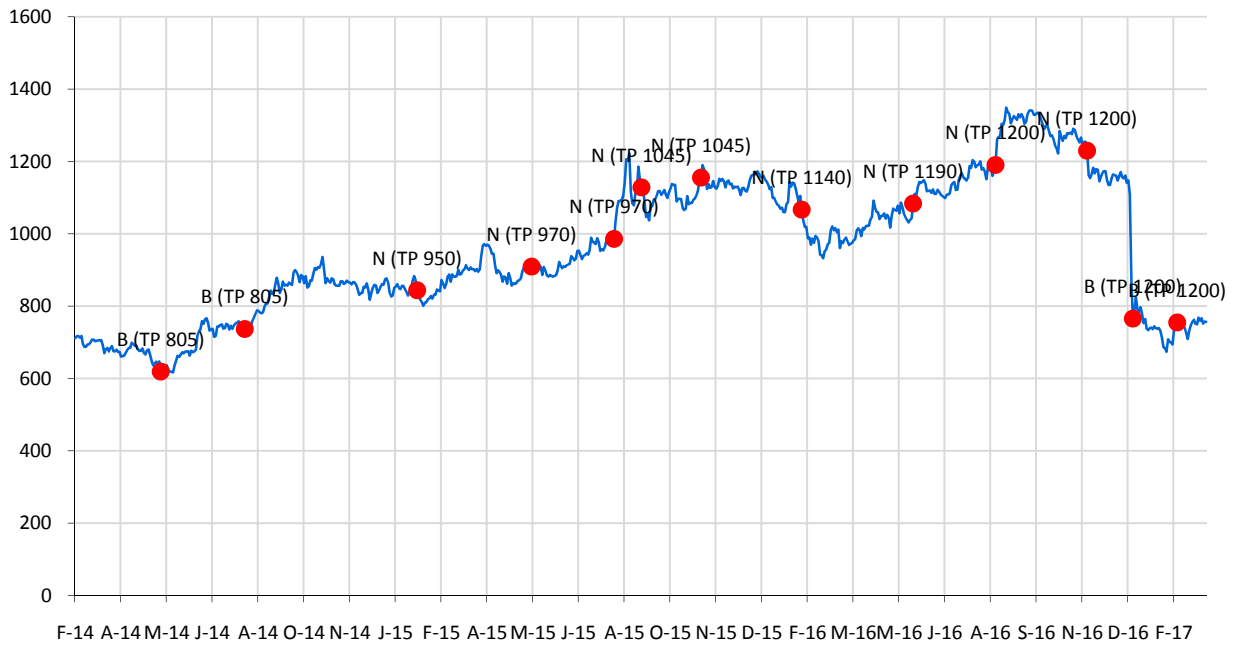
|  | FY16          | FY17E         | FY18E         | FY19E         |
|--|---------------|---------------|---------------|---------------|
| Pre-tax profit                             | 13,781        | 15,415        | 12,952        | 14,548        |
| Depreciation                               | 1,182         | 1,390         | 1,635         | 1,803         |
| Chg in working capital                     | -5,754        | -4,111        | 170           | -2,096        |
| Total tax paid                             | -2,474        | -3,546        | -3,367        | -3,783        |
| Other operating activities                 | 0             | 0             | 0             | 0             |
| <b>Cash flow from operating activities</b> | <b>6,735</b>  | <b>9,149</b>  | <b>11,389</b> | <b>10,473</b> |
| Capital expenditure                        | -2,938        | -3,679        | -6,506        | -1,106        |
| Chg in investments                         | -695          | -2,000        | -2,000        | -2,000        |
| <b>Cash flow from investing activities</b> | <b>-3,633</b> | <b>-5,679</b> | <b>-8,506</b> | <b>-3,106</b> |
| Free cash flow                             | 3,797         | 5,471         | 4,884         | 9,367         |
| Debt raised/(repaid)                       | 159           | 237           | -39           | 61            |
| <b>Cash flow from financing activities</b> | <b>8,082</b>  | <b>8,912</b>  | <b>6,348</b>  | <b>7,629</b>  |
| Net chg in cash                            | 11,184        | 12,383        | 9,232         | 14,997        |

### Valuation Ratios

|                                | FY16   | FY17E   | FY18E  | FY19E |
|--------------------------------|--------|---------|--------|-------|
| <b>Per Share data</b>          |        |         |        |       |
| EPS (INR)                      | 41.0   | 44.7    | 36.1   | 40.6  |
| Growth, %                      | (36.9) | 9.2     | (19.3) | 12.3  |
| Book NAV/share (INR)           | 161.5  | 194.2   | 218.3  | 246.8 |
| FDEPS (INR)                    | 41.0   | 44.7    | 36.1   | 40.6  |
| CEPS (INR)                     | 45.4   | 49.9    | 42.3   | 47.3  |
| CFPS (INR)                     | 23.1   | 31.8    | 39.9   | 35.9  |
| <b>Return ratios</b>           |        |         |        |       |
| Return on assets (%)           | 23.8   | 21.8    | 15.4   | 15.5  |
| Return on equity (%)           | 25.9   | 23.0    | 16.5   | 16.4  |
| Return on capital employed (%) | 30.3   | 28.8    | 21.6   | 21.5  |
| <b>Turnover ratios</b>         |        |         |        |       |
| Asset turnover (x)             | 1.1    | 1.1     | 0.9    | 0.9   |
| Sales/Total assets (x)         | 0.8    | 0.8     | 0.7    | 0.7   |
| Sales/Net FA (x)               | 2.3    | 2.4     | 1.9    | 1.9   |
| Working capital/Sales (x)      | 0.5    | 0.5     | 0.6    | 0.6   |
| Receivable days                | 85.1   | 87.2    | 88.2   | 88.2  |
| Working capital days           | 185.1  | 192.4   | 203.3  | 202.1 |
| <b>Liquidity ratios</b>        |        |         |        |       |
| Current ratio (x)              | 5.2    | 5.4     | 5.6    | 6.3   |
| Quick ratio (x)                | 2.6    | 2.8     | 2.8    | 3.5   |
| Interest cover (x)             | 558.6  | 1,112.3 | 976.1  | 996.1 |
| Total debt/Equity (%)          | 1.0    | 1.3     | 1.1    | 1.0   |
| Net debt/Equity (%)            | (0.7)  | (1.1)   | (0.4)  | (6.8) |
| <b>Valuation</b>               |        |         |        |       |
| PER (x)                        | 15.2   | 13.9    | 17.3   | 15.4  |
| PEG (x) - y-o-y growth         | (0.4)  | 1.5     | (0.9)  | 1.2   |
| Price/Book (x)                 | 3.9    | 3.2     | 2.9    | 2.5   |
| EV/Net sales (x)               | 4.4    | 3.7     | 4.0    | 3.6   |
| EV/EBITDA (x)                  | 11.7   | 10.2    | 12.0   | 10.4  |
| EV/EBIT (x)                    | 12.2   | 10.7    | 12.7   | 11.1  |

Source: Company, PhillipCapital India Research Estimates

### Stock Price, Price Target and Rating History



### Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

| Rating  | Criteria                    | Definition  |
|---------|-----------------------------|---|
| BUY     | $\geq +15\%$                | Target price is equal to or more than 15% of current market price |
| NEUTRAL | $-15\% > \text{to} < +15\%$ | Target price is less than +15% but more than -15%                 |
| SELL    | $\leq -15\%$                | Target price is less than or equal to -15%.                       |

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