

Below expectations; Downgrade to Accumulate

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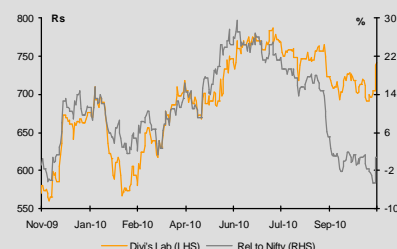
Reco	Previous Reco
Accumulate	Buy
CMP	Target Price
Rs723	Rs756
EPS change FY11E/12E (%)	-14 / -10
Target Price change (%)	-11
Nifty	6,302
Sensex	20,932

Price Performance

(%)	1M	3M	6M	12M
Absolute	2	(2)	8	31
Rel. to Nifty	(1)	(15)	(12)	2

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	Pharmaceuticals
Bloomberg	DIVI@IN
Equity Capital (Rs mn)	265
Face Value(Rs)	2
No of shares o/s (mn)	133
52 Week H/L	798/550
Market Cap (Rs bn/USD mn)	95/2,200
Daily Avg Volume (No of sh)	183774
Daily Avg Turnover (US\$m)	3.0

Shareholding Pattern (%)

	S'10	J'10	M'10
Promoters	52.2	52.4	52.4
FII/NRI	17.9	17.0	16.5
Institutions	12.4	13.4	14.0
Private Corp	8.2	8.1	7.4
Public	9.3	9.1	9.8

Source: Capitaline

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- **Divi's Q211 performance was below expectations with a) Revenue at Rs2.6bn (est. of Rs2.9bn); b) EBIDTA at Rs878mn (est. of Rs1.2bn) & c) APAT at Rs719mn (est. of Rs976mn)**
- **Unfavorable product mix impacted operating performance; expect gradual recovery going forward**
- **Carotenoids is the next growth driver for the company; to drive earnings growth in FY12E**
- **Tweak earning estimates by 14%/10% for FY11E/FY12E; Cut target price to Rs756 and downgrade the rating from Buy to Accumulate**

Adverse product mix and slower take-off impacted Q2 performance

Divi's Q2FY11 performance was mainly impacted because of slower pick-up and adverse product mix (lower contribution of CSS business). Despite 14% YoY growth in revenue, operating margins was down by 1331bps to 33.9% (lowest in last 14 quarters) mainly on the back of higher contribution of low margin products in the generic segment, currency appreciation and slower pick-up in custom synthesis business. Higher other income (up 67% YoY), lower interest cost (down by 82%) and lower tax provision (9.7% of PBT vs. 10.5% in Q2FY10) restricted PAT decline to 15% to Rs719mn (est. of Rs976mn).

Expect gradual recovery in 2H and full recovery in FY12E; Carotenoids to drive earnings growth in FY12E

We expect gradual recovery in 2HFY11E (15-16% growth) and full recovery in FY12E (upward of 22% growth). We expect operating margins to improve going forward to 37-38% for rest of FY11E and reach to upwards of 40% in FY12E driven by a) improved product mix, b) higher contribution of high margin Carotenoids business and c) commencement of Vizag SEZ facility. Overall we expect earning growth of 4% in FY11E which is likely to move up by 32% in FY12E on the back of a) increased outsourcing from global players post consolidation phase, b) restocking of the inventory and c) lower base effect. We believe that Carotenoids will be next growth driver for the company. Though the scale-up of Carotenoids took longer time than anticipated but now management is confident to attain higher revenue from this segment. Carotenoids segment did a revenue of Rs300mn in 1HFY11 (expect Rs700mn revenue in FY11E). We expect this business to record revenue of Rs1200mn in FY12E. We are of the view that since depreciation and interest cost on account of Carotenoids plant is already in P&L account; incremental contribution of Carotenoids will boost the profitability of the company.

Financials

YE-	Rs mn									
	Net Sales	EBITDA (Core)	EBITDA (%)	APAT	EPS (Rs)	EPS % chg	RoE (%)	P/E	EV/ EBITDA	P/BV
Mar										
FY09	11,852	4,861	41.0	4,166	31.4	19.9	39.6	23.0	19.8	7.7
FY10	9,501	4,137	43.5	3,403	25.6	(18.3)	24.7	28.2	23.3	6.3
FY11E	11,247	4,286	38.1	3,612	27.2	6.1	22.1	26.6	22.4	5.5
FY12E	13,725	5,552	40.4	4,759	35.9	31.8	24.8	20.2	17.3	4.6

Key Financials – Quarterly

Rs mn

Rs mn	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11	YoY (%)	QoQ (%)	YTD'11	YTD'10	YoY (%)
Revenue	2,275	1,963	3,141	2,648	2,589	13.8	(2.2)	5,237	4,333	20.9
Expenditure	1,200	1,144	1,628	1,645	1,711	42.5	4.0	3,356	2,592	29.5
<i>as % of sales</i>	<i>52.8</i>	<i>58.3</i>	<i>51.8</i>	<i>62.1</i>	<i>66.1</i>	<i>(5.47)</i>	<i>10.31</i>	<i>64.1</i>	<i>59.8</i>	<i>7.1</i>
Consumption of RM	644	546	992	1,000	1,026	59.4	2.6	2,026	1,494	35.6
<i>as % of sales</i>	<i>28.3</i>	<i>27.8</i>	<i>31.6</i>	<i>37.8</i>	<i>39.6</i>	<i>(3.56)</i>	<i>6.20</i>	<i>38.7</i>	<i>34.5</i>	<i>12.2</i>
Employee Cost	177	176	189	187	198	12.3	6.2	385	368	4.5
<i>as % of sales</i>	<i>7.8</i>	<i>9.0</i>	<i>6.0</i>	<i>7.1</i>	<i>7.7</i>	<i>(2.27)</i>	<i>1.02</i>	<i>7.3</i>	<i>8.5</i>	<i>-13.5</i>
Other expenditure	380	422	447	459	486	28.0	6.0	945	729	29.6
<i>as % of sales</i>	<i>16.7</i>	<i>21.5</i>	<i>14.2</i>	<i>17.3</i>	<i>18.8</i>	<i>0.36</i>	<i>3.09</i>	<i>18.0</i>	<i>16.8</i>	<i>7.2</i>
EBITDA	1,074	819	1,513	1,003	878	(18.2)	(12.4)	1,881	1,741	8.0
Depreciation	131	133	123	131	133	1.7	1.2	264	259	1.8
EBIT	944	687	1,390	871	746	(21.0)	(14.4)	1,617	1,482	9.1
Other Income	34	102	43	46	56	66.6	22.9	102	177	-42.2
Interest	30	18	-28	6	5	(82.5)	(3.6)	11	39	-71.9
PBT	947	771	1,462	912	797	(15.9)	(12.6)	1,708	1,620	5.4
Total Tax	100	93	168	74	77	(22.3)	4.0	152	189	-19.7
Adjusted PAT	848	678	1,294	837	719	(15.2)	(14.1)	1,557	1,431	8.8
(Profit)/loss from JV's/Ass/MI										
APAT after MI	848	678	1,294	837	719	(15.2)	(14.1)	1,557	1,346	15.6
Extra ordinary items	8	0	540	0	0			0	0	
Reported PAT	856	678	1,834	837	719	(16.0)	(14.1)	1,557	899	73.1
AEPS	6.4	5.1	9.7	6.3	5.4	(16.0)	(14.1)	11.7	10.2	14.9

Margins (%)						(bps)	(bps)			
EBIDTA	47.2	41.7	48.2	37.9	33.9	(1,331)	-394	35.9	40.2	-427
EBIT	41.5	35.0	44.3	32.9	28.8	(1,270)	-411	30.9	34.2	-333
EBT	41.7	39.3	46.5	34.4	30.8	(1,089)	-366	32.6	37.4	-477
PAT	37.3	34.6	41.2	31.6	27.8	(950)	-384	29.7	31.1	-135
Effective Tax rate	10.5	12.0	11.5	8.2	9.7	(80)	155	8.9	11.7	-278

Tweaking earning estimates by 14%/10%; cut target price and downgrade to Accumulate

Owing to lower than expected Q2FY11 performance and gradual recovery in CRAMS business, we cut our earning estimates by 14% and 10% to Rs27 and Rs36 for FY11E and FY12E respectively. We also cut our target price from Rs852 to Rs756 and downgrade our rating from Buy to Accumulate. We are of the view that Divi's would be key beneficiaries of improved global outsourcing environment. Best in class margins and return profile (RoIC in excess of 31%), strong balance sheet, India centric assets coupled with positive cash flow provides incremental comforts to the investors.

Financials

Income Statement

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
Net Sales	11,852	9,501	11,247	13,725
<i>Growth (%)</i>	14.1	-19.8	18.4	22.0
Expenditure	6,992	5,364	6,961	8,174
Raw Materials	4,253	3,032	4,114	4,785
SGA	1,766	1,304	1,657	1,965
Employee Cost	663	733	812	962
Other Exp	309	294	378	461
EBITDA	4,861	4,137	4,286	5,552
<i>Growth (%)</i>	17.0	-14.9	3.6	29.5
EBITDA margin (%)	41.0	43.5	38.1	40.4
Depreciation	479	515	593	679
EBIT	4,382	3,622	3,693	4,872
EBIT margin (%)	37.0	38.1	32.8	35.5
Other Income	172	259	432	542
Interest expenses	72	28	21	6
PBT	4,482	3,853	4,104	5,408
Tax	316	450	493	649
<i>Effective tax rate (%)</i>	7.0	11.7	12.0	12.0
Adjusted PAT	4,166	3,403	3,612	4,759
(Profit)/loss from JV's/Ass/MI	0	0	0	0
Adjusted PAT after MI	4,166	3,403	3,612	4,759
<i>Growth (%)</i>	19.9	-18.3	6.1	31.8
Net Margin (%)	35.2	35.8	32.1	34.7
E/O items	0	0	0	0
Reported PAT	4,166	3,403	3,612	4,759
<i>Growth (%)</i>	19.9	-18.3	6.1	31.8

Cash Flow

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
PBT (Ex-Other income)	4,310	3,595	3,672	4,866
Depreciation	479	515	593	679
Interest Provided	72	28	21	6
Other Non-Cash items	0	0	0	0
Chg in working cap	-1,856	147	942	-1,000
Tax paid	-316	-450	-493	-649
Operating Cashflow	2,689	3,834	4,736	3,902
Capital expenditure	-971	-557	-2,074	-1,378
Free Cash Flow	1,718	3,277	2,662	2,524
Other income	172	259	432	542
Investments	-1,162	-2,695	-506	-500
Investing Cashflow	-1,961	-2,993	-2,147	-1,337
Equity Capital Raised	68	297	0	0
Loans Taken / (Repaid)	-334	-197	-110	-100
Interest Paid	-72	-28	-21	-6
Dividend paid (incl tax)	-456	-925	-1,237	-1,546
Income from investments	0	0	0	0
Others	72	28	0	0
Financing Cashflow	-722	-824	-1,369	-1,652
Net chg in cash	6	17	1,220	914
Opening cash position	142	148	165	1,385
Closing cash position	148	165	1,385	2,298

Balance Sheet

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
Equity share capital	130	264	264	264
Reserves & surplus	12,284	14,914	17,289	20,502
Net worth	12,414	15,178	17,553	20,766
Minority Interest	0	0	0	0
Secured Loans	473	243	182	82
Unsecured Loans	53	87	37	37
Loan Funds	526	330	219	119
Net deferred tax liability	432	474	474	474
Total Liabilities	13,373	15,982	18,247	21,360
Gross Block	7,828	8,329	10,329	11,666
Less: Depreciation	1,929	2,431	3,022	3,700
Net block	5,899	5,898	7,307	7,966
Capital work in progress	195	238	310	350
Investment	1,718	4,413	4,919	5,419
Current Assets	7,672	8,040	8,985	11,563
Inventories	4,213	4,985	4,448	5,422
Sundry debtors	2,661	2,232	2,335	2,847
Cash & bank balance	148	165	1,385	2,298
Loans & advances	650	658	817	996
Other current assets	0	0	0	0
Current lia & Prov	2,111	2,607	3,273	3,938
Current liabilities	1,674	1,731	1,969	2,298
Provisions	437	876	1,304	1,640
Net current assets	5,561	5,433	5,711	7,625
Misc. exp & Def. Assets	0	0	0	0
Total Assets	13,373	15,982	18,247	21,360

Key Ratios

Y/E, Mar	FY09	FY10	FY11E	FY12E
Profitability (%)				
EBITDA Margin	41.0	43.5	38.1	40.4
Net Margin	35.2	35.8	32.1	34.7
ROCE	40.1	26.3	24.0	27.2
ROE	39.6	24.7	22.1	24.8
RoIC	45.4	32.0	32.2	38.9
Per Share Data (Rs)				
EPS	31.4	25.6	27.2	35.9
CEPS	35.0	29.5	31.7	41.0
BVPS	93.5	114.4	132.3	156.5
DPS	6.0	6.0	8.0	10.0
Valuations (x)				
PER	23.0	28.2	26.6	20.2
P/CEPS	20.7	24.5	22.8	17.6
P/BV	7.7	6.3	5.5	4.6
EV / Sales	8.1	10.1	8.6	7.0
EV / EBITDA	19.8	23.3	22.4	17.3
Dividend Yield (%)	0.7	0.8	1.1	1.4
Gearing Ratio (x)				
Net Debt/ Equity	0.0	0.0	-0.1	-0.1
Net Debt/EBIDTA	0.1	0.0	-0.2	-0.4
Working Cap Cycle (days)	180	236	183	185

Recommendation History: Divi's Laboratories Ltd – DIVI IN

Date	Reports	Reco	CMP	Target
13/08/2010	Divi's Laboratories Q1FY11 Result Update	Buy	748	852
01/07/2010	Divi's Laboratories Management Meet Update	Buy	779	852
24/05/2010	Divi's laboratories Q4FY10 Result Update	Buy	690	731
01/02/2010	Divi's laboratories Q3FY10 Result Update	Hold	610	566

Recent Research Reports

Date	Reports	Reco	CMP	Target
10/11/2010	Sun Pharma Q2FY11 Result Update	Hold	2,318	2,300
09/11/2010	Aurobindo Pharma Q2FY11 Result Update	Buy	1,343	1,581
29/10/2010	GlaxoSmithKline Pharma Q3CY10 Result Update	Hold	2,262	2,020
25/10/2010	Torrent Pharma Q2FY11 Result Update	Buy	558	650

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