2QFY07 Results Update
SECTOR: PHARMACEUTICALS

MOTILAL OSWAL

Divi's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,024	DIVI IN
	REUTERS CODE
S&P CNX: 3,769	DIVI.BO

Equity Shares (m)	12.8
52-Week Range	2,678/1,118
1,6,12 Rel. Perf. (%)	17/30/31
M.Cap. (Rs b)	33.4
M.Cap. (US$ b)	0.7

30 October 2006

Neutral

Previous Recommendation: Buy

Rs2,606

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/06A	3,811	700	54.6	5.1	47.7	9.8	22.4	26.8	9.1	29.8
03/07E	6,501	1,119	87.3	59.8	29.9	7.8	29.1	32.1	5.4	19.2
03/08E	7,909	1,514	118.1	35.3	22.1	6.1	30.9	33.3	4.5	15.0

Divi's Labs 2QFY07 performance was substantially better than estimates. Key highlights:

- Net sales grew by 98% (compared to estimate of 80%) while PAT grew by 96% to Rs313m (compared to estimates of Rs232m). Significant growth in both the generics and custom chemical synthesis (CCS) business (each business grew by almost 100%) has led the top-line growth. The increase in business is due to significant growth in sales to innovator companies for the CCS business and higher traction in generics sales (Naproxen, Dextromethrophan, Diltiazem, etc). We believe that consolidation amongst large innovator pharmaceutical companies over the past few years has led to closing down of capacities for certain older generics benefiting Divi's generics business.
- However, EBITDA margins declined by 560bp to 26.9% due to higher generic supplies, which enjoy lower margins as compared to its CCS business. Higher staff costs (up by 160% due to ESOP charges of Rs70m) and higher material costs (up by 150%) also adversely impacted EBITDA margins for the quarter.

We have revised our FY07E and FY08E EPS estimates upwards by 8% and 21% to factor in higher than expected momentum in both generics and CCS business. We expect Divi's to be one of the key beneficiaries of increased pharmaceutical outsourcing from India. The company's existing relationships with innovator companies should help it in procuring more MNC contracts. While we remain extremely positive about Divi's future prospects, rich valuations at 30x FY07E and 22x FY08E earnings has tempered down our optimism. We downgrade the stock from Buy to **Neutral**.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Op Revenue	**646**	**814**	**1,080**	**1,271**	**1,608**	**1,614**	**1,495**	**1,784**	**3,811**	**6,501**
YoY Change (%)	*5.4*	*7.8*	*6.8*	*16.1*	*148.8*	*98.3*	*38.5*	*40.3*	*9.7*	*70.6*
Total Expenditure	443	549	769	883	1,148	1,179	1,130	1,226	2,644	4,683
EBITDA	**203**	**265**	**311**	**388**	**461**	**435**	**365**	**557**	**1,167**	**1,818**
Margins (%)	*31.5*	*32.5*	*28.8*	*30.5*	*28.6*	*26.9*	*24.4*	*31.2*	*30.6*	*28.0*
Depreciation	36	37	37	39	43	42	65	75	148	224
Interest	11	9	14	21	21	6	40	53	56	120
Other Income	37	22	22	26	44	34	40	30	106	148
PBT	**193**	**241**	**282**	**354**	**441**	**421**	**300**	**459**	**1,069**	**1,622**
Tax	64	77	89	103	167	114	69	55	333	405
Deferred Tax	1	4	4	22	6	-6	12	85	31	97
Rate (%)	*33.8*	*33.7*	*33.0*	*35.3*	*39.4*	*25.7*	*27.0*	*30.5*	*34.1*	*31.0*
Adj PAT	**128**	**159**	**189**	**229**	**267**	**313**	**219**	**319**	**705**	**1,119**
YoY Change (%)	*-11.0*	*18.3*	*24.0*	*-0.3*	*109.6*	*96.2*	*16.0*	*39.5*	*6.7*	*58.8*
Margins (%)	*19.7*	*19.6*	*17.5*	*18.0*	*16.6*	*19.4*	*14.7*	*17.9*	*18.5*	*17.2*

E: MOSt Estimates

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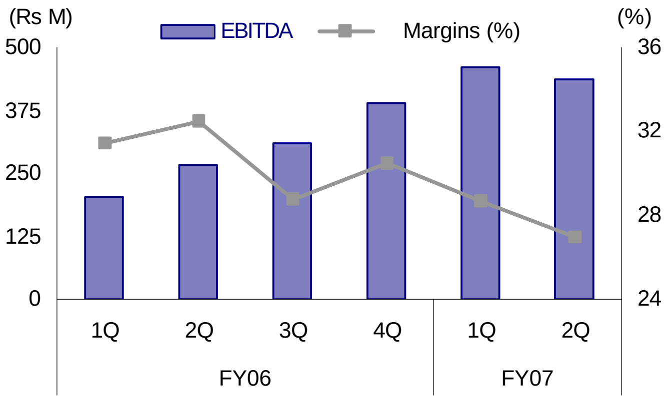
Significant growth in both generics and CCS businesses

Net sales during the quarter grew by 98% to Rs1.6b, based on significant growth in both the generics and custom chemical synthesis (CCS) business (each business grew by almost 100%). The increase in business is due to significant growth in sales to innovator companies for the CCS business and higher traction in generics sales (Naproxen, Dextromethrophan, Diltiazem, etc). We believe that consolidation amongst large innovator pharmaceutical companies over the past few years has led to closing down of capacities for certain older generics benefiting Divi's generics business.

Higher generic sales and increased staff costs impact EBITDA margins

EBITDA margins declined by 560bp to 26.9% due to higher generic supplies, which enjoy lower margins as compared to its CCS business. Higher staff costs (up by 160% due to ESOP charges of Rs70m) and higher material costs (up by 150%) also adversely impacted EBITDA margins for the quarter.

TREND IN EBITDA



Source: Company/Motilal Oswal Securities

Generics business: Global M&A leads to significant traction

Divi's generics business accounted for about 72% of FY06 revenues and is hence, the company's most important segment. Its older generic products – Naproxen, Diltiazem and Dextromethorphan (together accounting for about 49% of FY06 sales) – enjoy strong positioning. For these three products, the company features among the top-3 globally. These products have already been genericised and are growing at a steady 10% YoY. Since the pricing for these products has already stabilized (as the products are in the mature phase of the life cycle), we expect steady growth of 8-10% for these products over the next few years. We expect Divi's to retain its dominance in these products.

However, 2QFY07 witnessed Divi's generics business growing by more than 100% led mainly by a shift in sourcing arrangements post global M&As in the pharmaceutical industry. The company has indicated increased market share for these traditional generics as sourcing contracts have shifted in favour of the company. While no further details are available, we believe that this shift in sourcing will continue for some more quarters (in FY07E) resulting in an exponential growth in Divi's generic supplies.

Divi's would also see incremental contribution from new generic products. The company has total of 24 USFDA DMFs. Divi's is targeting a pipeline of 25-30 generic products going off patent over the next 5-10 years. We believe that Divi's would be commercializing most of these products from FY08E onwards.

CCS business: to expand in the coming years

Divi's CCS business contributed about 27% of its turnover in FY06. The company is currently working with the top-20 global innovator companies. It enjoys a good reputation with innovator companies and has been able to effectively demonstrate its chemistry skills. This has resulted in the company commanding the largest CCS pipeline from India (further details not disclosed).

2QFY07 saw Divi's CCS business grow by about 100% led mainly by increased sourcing by the innovators (as products move from clinical trials into commercialization). This growth has to be viewed in conjunction with the slow-down in the CCS business that Divi's witnessed in FY06 due to slow progress at the customer's end. Since the CCS business is linked to the progress of the NCE in the innovator's R&D pipeline, revenues from CCS supplies tend to be lumpy and unpredictable. These risks/uncertainties are an inherent part of the CCS business.

Carotenoids - Divi's initially targeting the US$1b market

Divi's has identified eight carotenoids like Beta-carotene, Lycopene, Astaxanthin and Canthaxanthin as its key products in this segment. It has already developed them in the laboratory and on a process scale. It has sent some of these carotenoids for evaluation to its leading customers and plans to start manufacturing them in the near future. The management believes that an early entry in this segment will enable it to entrench itself and take on the competition.

We believe that the global market for carotenoids has good potential, given their application in diverse industries like food processing, cosmetics and neutraceuticals. However, Divi's supply of carotenoids is likely to ramp up very gradually since it may be difficult to dislodge well-entrenched players like Roche and BASF. We expect Divi's to participate in the incremental growth in the Carotenoids market in the initial years till the time it is able to establish its credentials in the market.

Divi's is in the process of setting up the required facilities for converting 100% pure carotenoids in to granules (beadlet technology) which can be used by its customers directly. This facility is likely to be ready by end-FY07E and supplies are likely to commence in FY08E post receipt of regulatory approvals. We estimate supplies worth US$10m (~ 1% market share) in FY08E from this facility.

Divi's has recently floated two subsidiaries in regulated markets which will cater to the company's business development requirements (including that for carotenoids). The company has already commenced business development activities through these subsidiaries.

Benefits of capacity expansion to accrue from FY08E

Divi's in the process of setting up a new API unit at Vizag (AP) with SEZ status at a capex of Rs3b spread over the next few years. It expects to spend about Rs800m in the first phase of expansion. It has raised US$15m in forex loans to fund the first phase of the SEZ. The company has ruled out any equity dilution to fund its capex. Our estimates factor in the impact of additional interest outgo on account of the forex loan.

This project is likely to enjoy fiscal benefits (income tax, excise duty, import duties and sales tax) under the government's SEZ policy. The first phase of this facility has been commissioned on 27 October 2006 and is expected to commence contributing to revenues from 4QFY07 onwards, while the full benefits of the capacity expansion are likely to be visible in FY08E.

Revising estimates

We have revised our earnings estimates upwards for Divi's to factor in the significantly higher than expected momentum in both generic and CCS business. In generic business, most of the older products are witnessing strong growth, whereas in CCS business there has been significant growth in sales to innovator companies. We have revised our FY07E EPS upwards by 8% to Rs87.3 and FY08E EPS by 21% to Rs118.1.

REVISED FORECAST (RS M)

	FY07E			FY08E		
	REV	OLD	CHG (%)	REV	OLD	CHG (%)
Net Sales	6,501	6,364	2.2	7,909	7,103	11.3
Net Profit	1,119	1,032	8.4	1,514	1,250	21.1
EPS (Rs)	87.3	80.5	8.4	118.1	97.5	21.1

Source: Motilal Oswal Securities

Valuation and view

In our opinion, the key issues that will determine Divi's future valuations are:

- Growth in its custom chemical synthesis (CCS) business.
- Ability to maintain steady growth in the generic API and intermediates segment.
- Ramp-up of carotenoids business.

Generic business growth likely to be more gradual in FY08E

Divi's generics business is likely to witness exponential growth in FY07E due to the shift in sourcing of traditional generics in favor of the company. This has been mandated by the increased M&A activity in the global pharmaceutical space. We believe that this traction in Divi's generics business is likely to last till FY07E end and then revert back to the more gradual 8-10% growth band in FY08E. However, Divi's is likely to launch some of the newer generics (already filed with the US FDA) in FY08E which could add incrementally to the company's generics business.

CCS business will continue to have strong traction

We believe that Divi's will be one of the key beneficiaries of the increased pharmaceutical outsourcing from India. It's IPR compliance policies coupled with strong relationships with innovator pharmaceutical companies will ensure that the CCS business continue to grow strongly led by new contracts and ramp-up in existing contracts. However, as there is no visibility on these growth opportunities (as the company is bound by confidentiality clauses of disclosure), we have not factored in these potential upsides in our estimates for FY08E. We note that this business has grown by more than 100% in 1HFY07.

Divi's business model is different from most pharmaceutical companies in India. It focuses on partnering with global innovator MNCs and aims to be their preferred supplier. It is developing capabilities to partner its multinational customers through the entire value chain of drug discovery, commercialization and the off-patent phase.

This implies a long-term relationship with such customers and can result in a sustainable revenue stream for the CCS business, since a successfully commercialized MNC product will enjoy a monopoly for at least 8-10 years. The relationship also ensures that the company strictly adheres to the IPR regime – it will not file any patent challenges. This eliminates the uncertainties associated with patent challenges, which weigh on the valuations of most generic pharmaceutical companies.

We expect the company to deliver consistent RoE of about 25-30% despite the significant capex. We expect pharmaceutical outsourcing to gain traction from FY07E, with the top-5 players likely to gain a disproportionate share of the CRAMS business initially. We expect Divi's to be one of the key beneficiaries of increased pharmaceutical outsourcing from India. The company's existing relationships with innovator companies should help it in procuring more MNC contracts. While we remain extremely positive about Divi's future prospects, rich valuations at 30x FY07E and 22x FY08E earnings has tempered down our optimism. We downgrade the stock to **Neutral** with revised target price of Rs2,360.

Divi's Laboratories: an investment profile

Company Description

Divi's Labs is one of the leading players in the CRAMS segment and has one of the strongest CCS pipeline. The company enjoys good relationships with innovator pharmaceutical companies.

Key investment arguments

- We expect Divi's to be one of the key beneficiaries of increased pharmaceutical outsourcing from India.
- Divi's pipeline of late-stage and commercialized products coupled with the execution of new contract manufacturing assignments is likely to augur well for the company's CRAMS business.

Key investment risks

- The CCS business' success is linked to the fortunes of its MNC customers, especially their drug discovery pipeline.
- Since the agreements between Divi's and its MNC customers are confidential, there is no visibility on the potential of the CCS business.
- The company's ability to sustain its long-term relationships with its multinational customers would also critically determine the longevity of the CCS business.

Recent developments

- Commissioned first phase of SEZ at Vizag
- Reimbursed Rs240m for termination of a contract for a specialty ingredient, for which it had spent about Rs250m on setting a facility dedicated to this product

Valuation and view

- Revenue and Earnings CAGR of 44% and 47% expected over FY06-FY08E
- Valuations at 30x FY07E and 22x FY08E are rich.
- Downgrade recommendation to **Neutral** with price target of Rs2,360.

Sector view

- India is on the threshold of a significant opportunity in the contract manufacturing space. We expect increased outsourcing from India as it offers a unique proposition of low costs coupled with chemistry and regulatory skills.
- We expect contract manufacturing to be a US$1b opportunity for India by 2010 compared to the current size of US$100m.
- High entry barriers will ensure that the top 6-7 players will command a disproportionate share of this opportunity.

COMPARATIVE VALUATIONS

		DIVI'S LAB	NPIL	SHASUN
P/E (x)	FY07E	29.9	23.0	869.7
	FY08E	22.1	17.2	9.3
P/BV(x)	FY07E	7.8	4.7	2.0
	FY08E	6.1	4.1	1.7
EV/Sales(x)	FY07E	5.4	2.3	0.7
	FY08E	4.5	2.0	0.6
EV/EBITDA(x)	FY07E	19.2	14.7	6.6
	FY08E	15.0	12.0	4.9

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoters	53.9	53.9	54.0
Domestic Institutions	11.2	10.2	7.0
FIIs/FDIs	16.9	17.9	20.6
Others	18.0	18.0	18.4

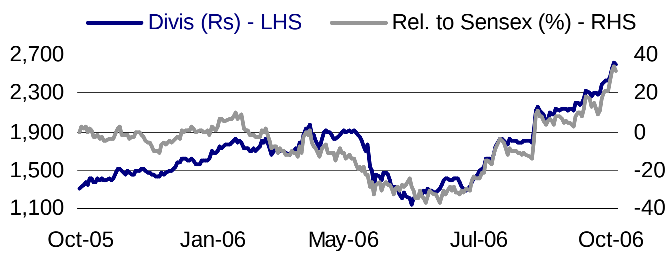
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	87.3	-	-
FY08	118.1	-	-

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
2,606	2,360	-9.4	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	**3,474**	**3,811**	**6,501**	**7,909**	**9,267**
Change (%)	*14.7*	*9.7*	*70.6*	*21.7*	*17.2*
Total Expenditure	2,428	2,644	4,683	5,558	6,386
% of Sales	*69.9*	*69.4*	*72.0*	*70.3*	*68.9*
EBITDA	**1,046**	**1,167**	**1,818**	**2,351**	**2,881**
Margin (%)	*30.1*	*30.6*	*28.0*	*29.7*	*31.1*
Depreciation	151	148	224	289	358
EBIT	**895**	**1,019**	**1,594**	**2,061**	**2,523**
Int. and Finance Charges	43	56	120	174	186
Other Income - Rec.	171	106	148	186	205
PBT before EO Expense	1,024	1,069	1,622	2,074	2,542
Extra Ordinary Expense/(Inc	0	0	0	0	0
PBT after EO Expense	1,024	1,069	1,622	2,074	2,542
Current Tax	330	338	405	415	508
Deferred Tax	27	31	97	145	51
Tax Rate (%)	*34.9*	*34.5*	*31.0*	*27.0*	*22.0*
Reported PAT	**661**	**705**	**1,119**	**1,514**	**1,983**
PAT Adj for EO Items	**666**	**700**	**1,119**	**1,514**	**1,983**
Change (%)	*-9.0*	*5.1*	*59.8*	*35.3*	*31.0*
Margin (%)	*19.2*	*18.4*	*17.2*	*19.1*	*21.4*

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	**52.0**	**54.6**	**87.3**	**118.1**	**154.7**
Cash EPS	63.7	66.2	104.8	140.7	182.6
BV/Share	221.3	265.9	334.6	429.1	552.9
DPS	8.0	10.0	16.3	20.7	27.1
Payout (%)	17.7	20.7	21.2	20.0	20.0
Valuation (x)					
P/E		47.7	29.9	22.1	16.8
Cash P/E		39.4	24.9	18.5	14.3
P/BV		9.8	7.8	6.1	4.7
EV/Sales		9.1	5.4	4.5	3.7
EV/EBITDA		29.8	19.2	15.0	12.0
Dividend Yield (%)		0.4	0.6	0.8	1.0
Return Ratios (%)					
RoE	26.0	22.4	29.1	30.9	31.5
RoCE	33.1	26.8	32.1	33.3	32.1
Working Capital Ratios					
Debtor (Days)	106	102	178	189	116
Creditor (Days)	154	248	130	134	138
Inventory (Days)	146	176	110	110	110
Working Capital Turnover (I	197	205	171	170	169
Leverage Ratio (x)					
Current Ratio	3.4	2.7	3.2	3.2	3.6
Debt/Equity	0.2	0.4	0.4	0.4	0.3

BALANCE SHEET					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Equity Share Capital	128	128	128	128	128
Total Reserves	2,708	3,280	4,161	5,373	6,959
Net Worth	**2,837**	**3,408**	**4,290**	**5,501**	**7,087**
Deferred liabilities	250	282	379	524	575
Total Loans	661	1,502	1,650	2,055	2,360
Capital Employed	**3,748**	**5,192**	**6,318**	**8,080**	**10,022**
Gross Block	2,538	3,019	4,019	5,019	6,019
Less: Accum. Deprn.	723	871	1,095	1,384	1,743
Net Fixed Assets	**1,815**	**2,148**	**2,924**	**3,634**	**4,276**
Capital WIP	11	803	80	100	120
Investments	0	4	100	400	100
Curr. Assets	**2,717**	**3,546**	**4,663**	**5,713**	**7,641**
Inventory	1,390	1,839	1,950	2,373	2,780
Account Receivables	1,022	1,074	2,145	2,610	3,058
Cash and Bank Balance	45	101	177	256	1,247
Loans & Advances	260	532	390	475	556
Curr. Liability & Prov.	**795**	**1,309**	**1,448**	**1,768**	**2,116**
Account Payables	668	1,152	1,170	1,424	1,668
Provisions	127	158	278	344	447
Net Current Assets	**1,922**	**2,237**	**3,215**	**3,945**	**5,526**
Appl. of Funds	**3,748**	**5,192**	**6,318**	**8,080**	**10,022**

E: MOSt Estimates

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Oper. Profit/(Loss) before T	1,046	1,167	1,818	2,351	2,881
Interest/Dividends Recd.	171	106	148	186	205
Direct Taxes Paid	-330	-338	-405	-415	-508
(Inc)/Dec in WC	-493	-259	-902	-652	-590
CF from Operations	**394**	**677**	**659**	**1,470**	**1,988**
EO Expense / (Income)	0	0	0	0	0
CF from Operating incl	**394**	**677**	**659**	**1,470**	**1,988**
(inc)/dec in FA	-259	-1,272	-278	-1,020	-1,020
(Pur)/Sale of Investments	1	-4	-96	-300	300
CF from Investments	**-258**	**-1,276**	**-374**	**-1,320**	**-720**
Issue of Shares	1	13	0	0	0
(Inc)/Dec in Debt	2	841	148	405	305
Interest Paid	-43	-56	-120	-174	-186
Dividend Paid	-117	-146	-238	-303	-397
Others	-5	4	0	0	0
CF from Fin. Activity	**-163**	**656**	**-210**	**-71**	**-277**
Inc/Dec of Cash	**-27**	**56**	**76**	**79**	**991**
Add: Beginning Balance	72	45	101	177	256
Closing Balance	**45**	**101**	**177**	**256**	**1,247**

N O T E S

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Disclosure of Interest Statement	Divi's Laboratories
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No