

Equity | India | Pharmaceuticals
30 October 2006

2Q heightens visibility

2Q significantly ahead of MLe

Divi's reported Q2 net profit of Rs.299mn (87% growth YoY) which is a significant 25% ahead of MLe. Revenues at Rs.1.6bn (99% growth YoY) came in 14% ahead of MLe. EBITDA margin of 31% (adjusted for non-cash ESOP charge) is lower on YoY basis but is not a significant concern and we remain enthused by the strong volume growth. Reiterate BUY with a PO of Rs. 2,970 (13% potential upside).

We see strong visibility in business scale-up

Looking ahead we expect the coming quarters to reflect strong earnings momentum noting completion of the gestation phase. This includes higher visibility in scale-up of custom manufacturing and generics, improving product mix towards high margin custom manufacturing and lowering tax rate. Also, Divi's has made good progress in its nutraceuticals venture where we expect revenue take-off from FY08.

Recent outperformance marks beginning of a new trend

Despite the stock's 32% relative outperformance over the last 6 months, the strong earnings momentum and greater clarity on nutraceuticals will likely drive further outperformance. Further, the recent outperformance is after a period of prolonged underperformance since 2004, which reflects the beginning of a new trend in business fundamentals, in our view.

Rs2970/sh fair value builds Rs230/share for nutraceuticals

We value Divi's base business at Rs2740/sh (20x FY08E EPS, in line with its 2-yr historical average) and we value the nutraceuticals business at Rs230/sh, which gives a fair value of Rs2970/sh (13% potential upside).

Estimates (Mar)

(Rs)	2004A	2005A	2006E	2007E	2008E
Net Income (Adjusted - mn)	732	666	695	1,066	1,751
EPS	57.09	51.93	54.24	83.19	136.61
EPS Change (YoY)	33.3%	-9.0%	4.5%	53.4%	64.2%
Dividend / Share	8.00	8.00	10.00	10.00	10.00
Free Cash Flow / Share	17.87	37.22	(20.05)	10.15	90.46

Valuation (Mar)

	2004A	2005A	2006E	2007E	2008E
P/E	45.90x	50.47x	48.31x	31.51x	19.18x
Dividend Yield	0.305%	0.305%	0.382%	0.382%	0.382%
EV / EBITDA*	29.18x	28.47x	27.72x	19.08x	12.55x
Free Cash Flow Yield*	0.682%	1.42%	-0.765%	0.387%	3.45%
EV/Sales	11.30x	9.85x	8.98x	5.79x	4.08x

* For full definitions of *iQmethod*SM measures, see page 5.



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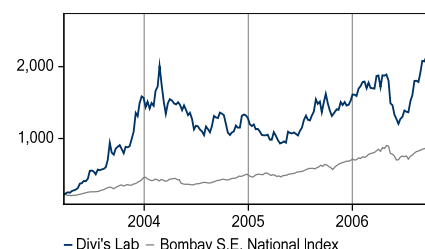
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Stock Data

Price	Rs2,621
Price Objective	Rs2,970
Date Established	17-Oct-2006
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs1,118-Rs2,678
Mkt Val / Shares Out (mn)	US\$743 / 12.8
Average Daily Volume	23,606
ML Symbol / Exchange	XXQPF / BSE
Bloomberg / Reuters	DIVI IN / DIVI.BO
ROE (2006E)	22.3%
Net Dbt to Eqty (Mar-2005A)	21.7%
Est. 5-Yr EPS / DPS Growth	18.0% / 0%
Free Float	46.0%



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Refer to important disclosures on page 6 to 7. Analyst Certification on page 4. Price Objective Basis/Risk on page 4.

iQprofileSM Divi's Laboratories

Key Income Statement Data (Mar)	2004A	2005A	2006E	2007E	2008E
(Rs Millions)					
Sales	3,160	3,630	3,890	5,983	8,461
Gross Profit	1,547	1,651	1,673	2,486	3,710
Sell General & Admin Expense	(302)	(365)	(352)	(543)	(772)
Operating Profit	1,040	1,051	1,086	1,567	2,459
Net Interest & Other Income	(20)	(28)	(29)	(65)	(80)
Associates	NA	NA	NA	NA	NA
Pretax Income	1,020	1,023	1,057	1,502	2,379
Tax (expense) / Benefit	(288)	(357)	(361)	(436)	(628)
Net Income (Adjusted)	732	666	695	1,066	1,751
Average Fully Diluted Shares Outstanding	13	13	13	13	13

Key Cash Flow Statement Data

Net Income (Reported)	732	666	695	1,066	1,751
Depreciation & Amortization	132	151	148	226	268
Change in Working Capital	(648)	(493)	(246)	(813)	(1,173)
Deferred Taxation Charge	45	27	28	30	45
Other Adjustments, Net	307	384	391	519	668
Cash Flow from Operations	569	735	1,016	1,027	1,560
Capital Expenditure	(340)	(258)	(1,273)	(897)	(400)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(340)	(258)	(1,273)	(897)	(400)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(103)	(103)	(128)	(128)	(128)
Cash Flow from Financing	(202)	(504)	317	9	(741)
Free Cash Flow	229	477	(257)	130	1,160
Net Debt	587	616	1,397	1,738	1,845
Change in Net Debt	199	29	781	259	(244)

Key Balance Sheet Data

Property, Plant & Equipment	1,718	1,826	2,951	3,581	3,713
Other Non-Current Assets	1	0	0	83	433
Trade Receivables	867	1,022	1,074	1,618	2,298
Cash & Equivalents	72	45	105	162	230
Other Current Assets	1,176	1,650	2,360	3,158	4,368
Total Assets	3,834	4,543	6,491	8,601	11,043
Long-Term Debt	659	661	1,502	1,900	2,075
Other Non-Current Liabilities	223	250	279	284	290
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	660	795	1,311	1,840	2,558
Total Liabilities	1,542	1,706	3,092	4,025	4,923
Total Equity	2,292	2,837	3,399	4,577	6,120
Total Equity & Liabilities	3,834	4,543	6,491	8,601	11,043

iQmethodSM - Bus Performance*

Return On Capital Employed	27.7%	20.0%	16.4%	19.0%	24.0%
Return On Equity	36.9%	26.0%	22.3%	26.7%	32.7%
Operating Margin	34.3%	30.3%	28.5%	26.5%	29.3%
EBITDA Margin	37.1%	33.1%	31.7%	30.0%	32.2%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	0.8x	1.1x	1.5x	1.0x	0.9x
Asset Replacement Ratio	2.6x	1.7x	8.6x	4.0x	1.5x
Tax Rate (Reported)	28.2%	34.9%	34.2%	29.0%	26.4%
Net Debt-to-Equity Ratio	25.6%	21.7%	41.1%	38.0%	30.2%
Interest Cover	30.9x	24.4x	19.4x	16.8x	22.5x

Key Metrics

Sales Growth (YoY)	22.8%	14.7%	9.7%	55.0%	42.0%
EBITDA Growth (YoY)	45.9%	2.5%	2.7%	45.3%	52.1%
Net Income Growth (YoY)	33.3%	-9.0%	4.5%	53.4%	64.2%
Net Profit Margin	23.2%	18.3%	17.9%	17.8%	20.7%

* For full definitions of iQmethodSM measures, see page 5.

Company Description

Divi's Labs is positioned in the US\$18bn global pharmaceutical outsourcing market as a research focused custom manufacturing player (bulk drugs/intermediates). About 30% of Divi's revenues (FY05) is derived from development and contract manufacturing (custom manufacturing) of APIs / intermediates for inventor companies, while the balance is derived from generic exports where it derives strong economies of scale and competes globally.

Stock Data

Price to Book Value	9.9x
Market Cap (US\$ mn)	743

2QFY07 Variance Table

Table 1: Divi's Laboratories Quarterly Results

Year to Mar (Rs mn)	2QFY06	2QFY07	YoY %	Comments
Net Sales	814	1,617	99%	Sharp 99% YoY revenue growth is 14% ahead of MLe driven by overall growth in both generics and custom manufacturing as well as commercialisation of the SEZ unit at Chippada
Other operating income	22	35	59%	
Total income	836	1,652	98%	
Raw material consumed	338	851	152%	
Staff cost	40	116	194%	Rs.116 mn staff includes Rs 61mn ESOP charge which is non cash
Manufacturing expenses	85	94	11%	
Other Expenses	87	140	61%	
Total Expenditure	549	1,201	119%	
Operating profit	286	451	57%	Gross margins lower by 200 basis points QoQ could reflect a changed product mix
<i>OPM (%)</i>	<i>34%</i>	<i>27%</i>	<i>-20%</i>	If one were to adjust for the non cash ESOP charge, EBITDA margin was at 31%
Interest (net)	(9)	(6)	-31%	
Depreciation	(37)	(42)	14%	
Pre-tax profits	241	403	67%	Tax rate down to 26% versus 34% for the same quarter last year (due to commercialization of Chippada SEZ unit)
Tax	(81)	(104)	28%	
Net income	160	299	87%	PAT for 2QFY07 25% ahead of our estimate

Source: Merrill Lynch Research

Price Objective Basis & Risk

We value Divi's base business at Rs2740/sh (20x FY08E EPS, in line with its 2-yr historical average) and we value the neutraceuticals business at Rs230/sh, which gives a theoretical fair value of **Rs2970/sh**.

Risks to our PO: (a) Regulatory delays in take-off of neutraceuticals business; (b) severance of custom manufacturing relationships; (c) price fluctuation in the generics market; and (d) delays in plant commissioning.

Analyst Certification

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30 October 2006

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

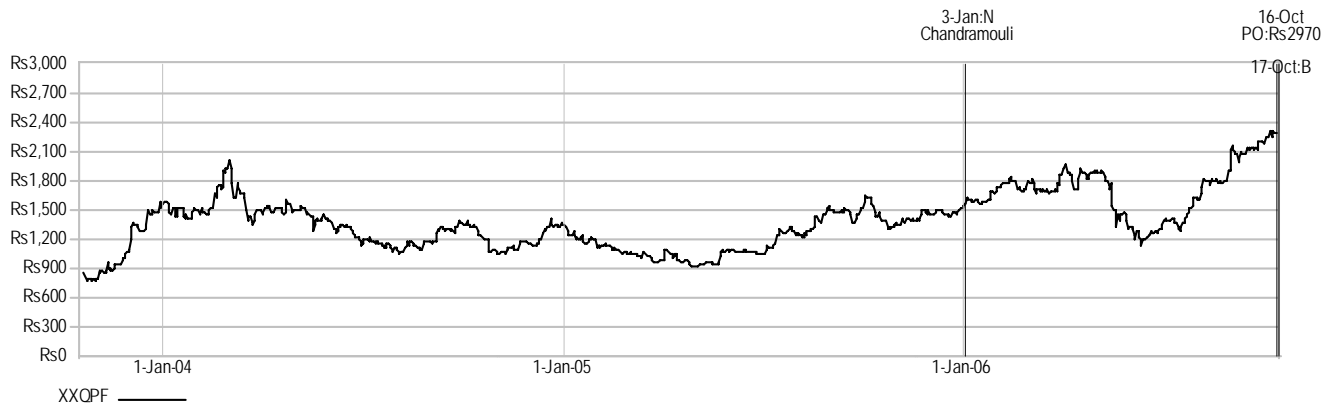
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XXQPF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

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Investment Rating Distribution: Health Care Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	87	43.28%	Buy	28	32.18%
Neutral	99	49.25%	Neutral	25	25.25%
Sell	15	7.46%	Sell	1	6.67%

Investment Rating Distribution: Global Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1325	44.76%	Buy	434	32.75%
Neutral	1420	47.97%	Neutral	412	29.01%
Sell	215	7.26%	Sell	48	22.33%

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