MOTILAL OSWAL

1QFY07 Results Update

SECTOR: PHARMACEUTICALS

Divi's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,752	DIVI IN
	REUTERS CODE
S&P CNX: 3,148	DIVI.BO

Equity Shares (m)	12.8
52-Week Range	2,009/1,118
1,6,12 Rel. Perf. (%)	23/-14/-11
M.Cap. (Rs b)	20.7
M.Cap. (US$ b)	0.4

1 August 2006

Buy

Previous Recommendation: Buy

Rs1,619

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	705	55.0	5.8	29.4	6.1	22.6	26.3	5.9	19.2
03/07E	6,364	1,033	80.6	46.6	20.1	4.9	27.2	29.7	3.5	13.2
03/08E	7,103	1,250	97.5	21.0	16.6	4.0	26.5	28.7	3.2	11.4

Divi's Labs 1QFY07 performance was substantially better than estimates with sales growth of 149% and PAT growth of 110%. Key highlights:

- Net sales grew by 149% to Rs1.6b led by significant growth in both the generics and custom chemical synthesis (CCS) business (each business grew by more than 100%).
- However, EBITDA margins have declined by 290bp to 28.6%, due to higher contribution from the company's generic supplies, which have lower margins as compared to its CCS business (as reflected in higher material costs which is up by 260%). Also, higher staff costs (up by 145% due to ESOP charges of Rs60m) adversely impacted EBITDA margins for the quarter. Lower margins coupled with higher tax provisioning (at 39.4% of PBT v/s 33.8% in 1QFY06) resulted in PAT growth of 110% to Rs267m.
- Divi's has received a reimbursement of Rs239.5m from one of its partners in lieu of termination of a contract for a specialty ingredient, on which it had spent about Rs250m.
- We have revised our FY07E and FY08E EPS estimates upwards by 30.4% and 19.5% to factor in higher than expected momentum in both generics and CCS business. Our estimates do not include upsides from any future contracts that the company may announce or from the proposed Rs800m SEZ.

Divi's is expected to be one of the key beneficiaries of increased pharmaceutical outsourcing from India. Divi's existing relationships with innovator companies should help it in procuring more MNC contracts. The stock is currently valued at 20.1x FY07E and 16.6x FY08E earnings. **Maintain Buy** with revised price target of Rs1,950.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Net Op Revenue	**646**	**814**	**1,080**	**1,271**	**1,608**	**1,464**	**1,718**	**1,574**	**3,811**	**6,364**
YoY Change (%)	*5.4*	*7.8*	*6.8*	*16.1*	*148.8*	*79.8*	*59.1*	*23.8*	*9.7*	*67.0*
Total Expenditure	443	549	769	883	1,148	1,086	1,269	1,169	2,644	4,671
EBITDA	**203**	**265**	**311**	**388**	**461**	**377**	**450**	**405**	**1,167**	**1,693**
Margins (%)	*31.5*	*32.5*	*28.8*	*30.5*	*28.6*	*25.8*	*26.2*	*25.7*	*30.6*	*26.6*
Depreciation	36	37	37	39	43	55	65	73	148	236
Interest	11	9	14	21	21	30	40	43	56	134
Other Income	37	22	22	26	44	35	40	55	106	174
PBT	**193**	**241**	**282**	**354**	**441**	**327**	**385**	**344**	**1,069**	**1,497**
Tax	64	77	89	103	167	82	88	37	333	374
Deferred Tax	1	4	4	22	6	13	15	55	31	90
Rate (%)	*33.8*	*33.7*	*33.0*	*35.3*	*39.4*	*29.0*	*27.0*	*26.6*	*34.1*	*31.0*
Adj PAT	**128**	**159**	**189**	**229**	**267**	**232**	**281**	**252**	**705**	**1,033**
YoY Change (%)	*-11.0*	*18.3*	*24.0*	*-0.3*	*109.6*	*45.7*	*48.6*	*10.1*	*6.7*	*46.5*
Margins (%)	*19.7*	*19.6*	*17.5*	*18.0*	*16.6*	*15.9*	*16.3*	*16.0*	*18.5*	*16.2*

E: MOSt Estimates

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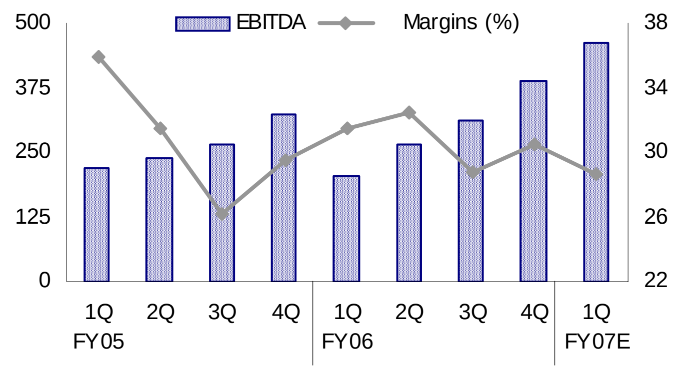
Significant growth in both generics and CCS businesses

Net sales during the quarter grew by 149% to Rs1.6b, based on significant growth in both the generics and custom chemical synthesis (CCS) business (each business grew by more than 100%). The company has indicated that the increase in business is due to significant growth in sales to innovator companies for the CCS business and increase in sales of the top 5 generic products (Naproxen, Dextromethrophan, Ipamidol, Nabumetone etc).

Higher generic sales and increased staff costs impact EBITDA margins

EBITDA margins have declined by 290bp to 28.6%, due to higher contribution from the company's generic supplies, which earns lower margins as compared to its CCS business (this is reflected in higher material costs which is up by 260%). Also, higher staff costs (up by 145% due to ESOP charges of Rs60m) adversely impacted EBITDA margins for the quarter. Lower margins coupled with higher tax provisioning (at 39.4% of PBT v/s 33.8% in 1QFY06) restricted PAT growth to 110% to Rs267m.

TREND IN EBITDA (RS M)



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, 1QFY07 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 the company 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-25 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).

1QFY07 saw Divi's CCS business grow by more than 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.

Receives reimbursement for termination of contract with a US-based MNC

In Mar-06, Divi's had announced cancellation of one of its contracts from a US based company. The client had instructed Divi's not to go ahead with the construction of the facilities for servicing this contract. The company has not disclosed the reasons for the cancellation of the contract but has indicated that it was not due to any problems in implementation.

However, it has received a reimbursement of Rs240m from its partners in lieu of termination of the contract. Divi's had spent about Rs250m on setting a facility dedicated to this product. The company has clarified that this income will not be reflected in the P&L since it is a capital receipt. Our current estimates already factor-in the impact of the cancellation of the contract. While we believe that the termination of contract was a negative development for Divi's, we also believe that this is a one-off development. Cancellation of contracts at the implementation stage is very rare while there have been instances of cancellation due to lower demand for the customer's products.

Management has indicated that this facility can be utilized for manufacture of neutraceuticals in the future. However, as of now we do not have visibility on how the company is likely to utilize this new facility.

Carotenoids - Divi's initially targeting the US$300m Astaxanthin 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. The company is targeting the US$300m Astaxanthin market (which is growing at about 15% annually) to begin with.

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 Astaxanthin market in the initial years till the time it is able to establish its credentials in the market.

Divi's is ready with 100% pure Astaxanthin, which its partner will have to convert to formulation before using it as feed. Divi's has been able to tie up with only one feed manufacturer till date. The company's manufacturing facility at Vizag includes a carotenoids unit. We expect only incremental upsides from carotenoids for Divi's, with revenues estimated at Rs118m for FY07E and Rs125m for FY08E.

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. Divi's has indicated commercialization of the unit by 2QFY07. Hence, the full benefits of the capacity expansion are likely to be visible only in FY08E. As there is no visibility on the products to be manufactured at this unit, we have not included any upsides from the commissioning of this unit in our estimates.

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 30% to Rs80.6 and FY08E EPS by 19.5% to Rs97.5.

REVISED FORECAST (RS M)

	FY07E			FY08E		
	REV	OLD	CHG(%)	REV	OLD	CHG(%)
Net Sales	6,364	4,337	46.7	7,103	4,928	44.1
Net Profit	1,033	792	30.4	1,250	1,046	19.5
EPS (Rs)	80.6	61.8	30.4	97.5	81.6	19.5

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 favour 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. While we have forecasted a 100% growth in the company's CCS business for FY07E (it has grown by more than 100% in 1QFY07), we have tempered it down to single-digit growth for FY08E.

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 25-27% despite the significant capex. Our earnings estimates represent the base-case scenario, as we have not included upsides from potential contracts or the new SEZ being set up by the company. 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. Divi's existing relationships with MNCs would help the company gain more contracts in the future. We have raised the target price to Rs1,950 (~20x FY08E EPS), in line with our earnings upgrade. Divi's is currently valued at 20.1x FY07E and 16.6x FY08E earnings. Maintain **Buy**.

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

- 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 36.5% and 33% expected over FY06-FY08E
- Valuations at 20.1x FY07E and 16.6x FY08E do not fully reflect the fact that Divi's will be one of the key beneficiaries of increased outsourcing from India.
- Re-iterate buy with price target of Rs. 1,950

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)	FY06E	20.1	20.6	631.3
	FY07E	16.6	15.4	7.3
P/BV(x)	FY06E	4.9	4.2	1.7
	FY07E	4.0	3.7	1.4
EV/Sales(x)	FY06E	3.5	2.1	0.6
	FY07E	3.2	1.8	0.5
EV/EBITDA(x)	FY06E	13.2	13.2	5.5
	FY07E	11.4	10.8	4.1

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	54.0	54.0	54.0
Domestic Institutions	8.8	7.9	6.9
FIIs/FDIs	19.7	21.0	20.3
Others	17.6	17.1	18.9

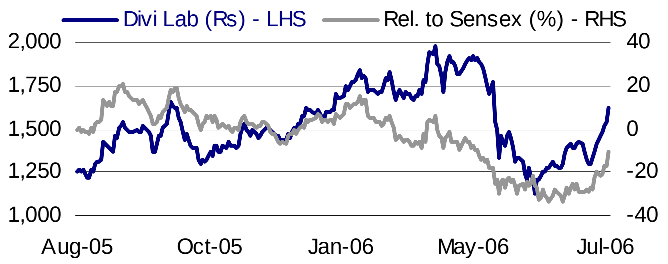
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	80.6	71.2	13.2
FY08	97.5	83.3	17.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,619	1,950	20.4	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Net Sales	**3,028**	**3,474**	**3,811**	**6,364**	**7,103**
Change (%)	*22.8*	*14.7*	*9.7*	*67.0*	*11.6*
Total Expenditure	1,987	2,428	2,644	4,671	5,115
% of Sales	*65.6*	*69.9*	*69.4*	*73.4*	*72.0*
EBITDA	**1,041**	**1,046**	**1,167**	**1,693**	**1,988**
Margin (%)	*34.4*	*30.1*	*30.6*	*26.6*	*28.0*
Depreciation	132	151	148	236	300
EBIT	**909**	**895**	**1,019**	**1,457**	**1,688**
Int. and Finance Charges	34	43	56	134	179
Other Income - Rec.	145	171	106	174	203
PBT before EO Expense	1,020	1,024	1,069	1,497	1,712
Extra Ordinary Expense/(Income)		0	0	0	0
PBT after EO Expense	1,020	1,024	1,069	1,497	1,712
Current Tax	243	330	333	374	342
Deferred Tax	45	27	31	90	120
Tax Rate (%)	*28.2*	*34.9*	*34.1*	*31.0*	*27.0*
Reported PAT	**728**	**661**	**705**	**1,033**	**1,250**
PAT Adj for EO Items	**732**	**666**	**705**	**1,033**	**1,250**
Change (%)	*33.2*	*-9.0*	*5.8*	*46.6*	*21.0*
Margin (%)	*24.2*	*19.2*	*18.5*	*16.2*	*17.6*

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	**28.5**	**52.0**	**55.0**	**80.6**	**97.5**
Cash EPS	33.7	63.7	66.5	99.0	120.9
BV/Share	89.4	221.3	264.9	328.3	406.3
DPS	8.0	8.0	10.0	15.0	17.1
Payout (%)	15.9	17.7	20.8	21.2	20.0
Valuation (x)					
P/E		31.1	29.4	20.1	16.6
Cash P/E		25.4	24.3	16.4	13.4
P/BV		7.3	6.1	4.9	4.0
EV/Sales		6.1	5.9	3.5	3.2
EV/EBITDA		20.4	19.2	13.2	11.4
Dividend Yield (%)		0.5	0.6	0.9	1.1
Return Ratios (%)					
RoE	36.9	26.0	22.6	27.2	26.5
RoCE	41.6	33.1	26.3	29.7	28.7
Working Capital Ratios					
Debtor (Days)	103	106	113	166	163
Creditor (Days)	154	156	147	126	131
Inventory (Days)	130	146	146	110	110
Working Capital Turnover (I	167	197	211	171	172
Leverage Ratio (x)					
Current Ratio	3.2	3.4	3.6	3.2	3.2
Debt/Equity	0.3	0.2	0.5	0.4	0.4

BALANCE SHEET					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Equity Share Capital	128	128	128	128	128
Total Reserves	2,164	2,708	3,267	4,080	5,080
Net Worth	**2,292**	**2,837**	**3,395**	**4,208**	**5,208**
Deferred liabilities	223	250	282	371	491
Total Loans	659	661	1,653	1,708	2,047
Capital Employed	**3,174**	**3,748**	**5,330**	**6,288**	**7,747**
Gross Block	2,236	2,538	3,138	4,138	5,138
Less: Accum. Deprn.	573	723	872	1,108	1,409
Net Fixed Assets	**1,663**	**1,815**	**2,266**	**3,030**	**3,730**
Capital WIP	55	11	63	83	103
Investments	1	0	750	100	400
Curr. Assets	**2,115**	**2,717**	**3,117**	**4,478**	**5,077**
Inventory	1,076	1,390	1,524	1,909	2,131
Account Receivables	867	1,022	1,258	2,100	2,344
Cash and Bank Balance	72	45	49	86	176
Loans & Advances	100	260	286	382	426
Curr. Liability & Prov.	**660**	**795**	**866**	**1,402**	**1,563**
Account Payables	532	678	686	1,146	1,279
Provisions	128	117	180	257	284
Net Current Assets	**1,455**	**1,922**	**2,251**	**3,075**	**3,514**
Appl. of Funds	**3,174**	**3,748**	**5,330**	**6,288**	**7,747**

E: MOSt Estimates

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Oper. Profit/(Loss) before T	1,041	1,046	1,167	1,693	1,988
Interest/Dividends Recd.	145	171	106	174	203
Direct Taxes Paid	-243	-330	-333	-374	-342
(Inc)/Dec in WC	-648	-493	-326	-786	-350
CF from Operations	**295**	**394**	**614**	**706**	**1,499**
EO Expense / (Income)	0	0	0	0	0
CF from Operating inc	**295**	**394**	**614**	**706**	**1,499**
(inc)/dec in FA	-340	-259	-651	-1,020	-1,020
(Pur)/Sale of Investments	0	1	-750	650	-300
CF from Investments	**-364**	**-263**	**-1,401**	**-370**	**-1,320**
Issue of Shares	0	1	0	0	0
(Inc)/Dec in Debt	225	2	992	55	339
Interest Paid	-34	-43	-56	-134	-179
Dividend Paid	-116	-117	-146	-219	-250
Others	20	0	0	0	0
CF from Fin. Activity	**96**	**-158**	**790**	**-298**	**-90**
Inc/Dec of Cash	**27**	**-27**	**4**	**38**	**89**
Add: Beginning Balance	45	72	45	49	86
Closing Balance	**72**	**45**	**49**	**86**	**176**

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

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