Divi's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,920	DIVI IN
	REUTERS CODE
S&P CNX: 3,001	DIVI.BO

Equity Shares (m)	12.8
52-Week Range	1,750/901
1,6,12 Rel. Perf. (%)	5/1/-1
M.Cap. (Rs b)	21.5
M.Cap. (US$ b)	0.5

31 January 2006

Buy

Previous Recommendation: Buy

Rs1,681

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
03/05A	3,474	666	52.0	82.1	32.3	7.6	26.0	33.1	6.4	21.2
03/06E	3,779	714	55.7	7.1	30.2	6.3	22.8	26.6	6.1	19.5
03/07E	4,537	835	65.1	17.0	25.8	5.2	22.1	24.4	5.1	16.5

Divi's Labs' 3QFY06 results were slightly better than expected. Net revenues grew 6.8% YoY to Rs1.08b (our estimate was Rs1.1b). CRAMS contributed 22% of revenues, Generics 71.5% and Peptides & Nucleotides the remaining 6.5%. EBITDA margins expanded 260bp YoY mainly due to a 3% decline in material consumption. PAT increased by 24% YoY to Rs189m, surpassing our estimate of Rs159m.

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. Its pipeline of late-stage and commercialized products coupled with the execution of new contract manufacturing assignments should augur well for its CRAMS business.

We expect Divi's to record earnings CAGR of 19.3% till FY08, led by reasonable top-line growth (14.6% CAGR) and a gradual 270bp margin expansion. Divi's is currently valued at 25.8x FY07E and 19.1x FY08E earnings. Our estimates, however, do not include upsides from any future contracts that the company may announce or from its proposed Rs800m SEZ. We maintain **Buy**.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Op Revenue	**614**	**755**	**1,011**	**1,095**	**646**	**814**	**1,080**	**1,239**	**3,474**	**3,779**
YoY Change (%)	*-0.3*	*24.4*	*22.8*	*11.4*	*5.4*	*7.8*	*6.8*	*13.2*	*14.7*	*8.8*
Total Expenditure	393	517	746	772	443	549	769	833	2,428	2,595
EBITDA	**220**	**238**	**264**	**323**	**203**	**265**	**311**	**406**	**1,045**	**1,185**
Margins (%)	*35.9*	*31.5*	*26.2*	*29.5*	*31.5*	*32.5*	*28.8*	*32.7*	*30.1*	*31.3*
Depreciation	36	38	39	37	36	37	37	40	151	149
Interest	7	8	14	14	11	9	14	38	43	73
Other Income	48	31	37	56	37	22	22	23	171	103
PBT	**225**	**222**	**248**	**328**	**193**	**241**	**282**	**350**	**1,023**	**1,065**
Tax	72	76	87	101	64	77	89	90	335	320
Deferred Tax	10	12	9	-3	1	4	4	23	27	32
Rate (%)	*36.2*	*39.3*	*38.6*	*30.0*	*33.8*	*33.7*	*33.0*	*32.1*	*35.5*	*33.0*
Adj PAT	**143**	**135**	**152**	**230**	**128**	**159**	**189**	**238**	**660**	**714**
YoY Change (%)	*-5.4*	*-13.1*	*-24.8*	*4.8*	*-11.0*	*18.3*	*24.0*	*3.4*	*-9.4*	*8.1*
Margins (%)	*23.4*	*17.9*	*15.1*	*21.0*	*19.7*	*19.6*	*17.5*	*19.2*	*19.0*	*18.9*

E: MOSt Estimates

Nimish Desai (Nimishdesai@MotilalOswal.com); Tel: +91 22 39825406/Jinesh K Gandhi (Jinesh@MotilalOswal.com); Tel +91 22 39825416

Generics business: to grow at a steady pace

Divi's generics business accounts for about 70% of its revenues and is hence, the company's most important segment. Its older generic products – Naproxen, Diltiazem and Dextromethorphan (together accounting for about 43% of FY05 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.

While its older products would continue to witness steady growth, Divi's would also see incremental contribution from new generic products. The company has filed two DMFs with the US-FDA during the quarter, taking the total to 26. 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 FY08 onwards. For Levetiracetam, we expect supplies to commence from 1QFY07.

As a policy, Divi's does not support patent challenges due to the clash of business interests with the innovators. However, it has been amongst the first to file DMFs for Levetiracetam (UCB's *Keppra* brand with sales of US$320m) and Proguanil (GSK's *Malarone*). Two generic companies have filed patent challenges for Levetiracetam, including Dr Reddy's. It seems that the other patent challenge may be supported by Divi's DMF for Levetiracetam. This contradicts Divi's stated policy of not entering into patent challenges against innovator companies. However, the company has indicated that it does not intend to back any patent challenges for this product.

CCS business: to expand in the coming years

Divi's CCS business contributed about 23% of its turnover in FY05 and about 22% for 3QFY06. We expect a gradual increase in this number to 25% by FY08. The company is currently working with 20 of 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, consisting of about 55 products, of which 25 are undergoing phase-III clinical trials. We believe that Divi's has the strongest CCS pipeline amongst Indian players.

Divi's has recently experienced a slowdown in its CCS business 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.

Supplies under new MNC contract to commence from FY07

Divi's has tied up with an MNC (based in the US) for supply of a specialty ingredient for which it is setting up a new facility at Vizag at a capex of Rs300m. The unit is likely to start supplies to the US partner from 1QFY07. Divi's would be catering to the global requirements of its partner for the latter's patented product. The Vizag unit would be set up under the government's SEZ scheme and would enjoy fiscal benefits.

The company has not disclosed the name of the product nor has it disclosed details of its partner for this contract. We assume that the investment of Rs300m would fetch peak revenues of Rs450m/year over the next three years (till FY09) for Divi's. The supply agreement is valid for at least five years. We expect a revenue contribution of about Rs200m from this contract in FY07, with a gradual ramp-up to Rs450m by FY09.

Carotenoids – 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. The company has been able to tie up with only one feed manufacturer till date. Its partner is in the process of setting up a plant for manufacturing Astaxanthin formulation. Divi's has indicated that commercial supplies will begin in the next 6-8 months. 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 FY07 and Rs125m for FY08.

Benefits of capacity expansion to accrue from FY08

Divi's in the process of setting up a new API unit at Vizag (AP) with SEZ status at a capex of Rs3b. It expects to spend about Rs800m (excluding the Rs300m for the MNC contract) in the first phase of expansion. It has already raised US$6m in long-term forex loans to fund the Rs300m unit for servicing the MNC contract. It plans to raise another 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 3QFY07. Hence, the full benefits of the capacity expansion are likely only in FY08.

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.

Divi's earnings are likely to witness19% CAGR through to FY08. We are forecasting just 7% bottom-line growth for FY06 to take into account the slowdown in Divi's CCS business as well as higher interest outgo due to increased borrowings. Earnings are expected to record 17% and 35% growth for FY07 and FY08, respectively.

Our estimates do not include upsides from future contracts, which the company may announce, as there is no visibility on these contracts at this juncture. Also, we have not factored in the revenue upside from the Rs800m SEZ likely to be commercialized by 3QFY07, as there is little visibility on the products to be manufactured at this facility.

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

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 over 20% 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 FY07, 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. Divi's is currently valued at 25.8x FY07E and 19.1x FY08E earnings. We 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

- Currently setting up a dedicated facility to service a MNC contract at a capex of Rs300m
- Investing Rs800m in setting up an SEZ for servicing the CRAMS and generics businesses.

Valuation and view

- Revenue and earnings CAGR of 14% and 19% expected over FY05-FY08
- Valuations at 25.8x FY07E and 19.1x 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 Rs1,764

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 and chemistry/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	30.2	38.9	14.9
	FY07E	25.8	22.2	11.9
P/BV (x)	FY06E	6.3	5.7	2.9
	FY07E	5.2	5.1	2.5
EV/Sales (x)	FY06E	6.1	3.3	1.5
	FY07E	5.1	2.8	1.3
EV/EBITDA (x)	FY06E	19.5	23.3	8.4
	FY07E	16.5	15.8	6.8

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	54.0	54.0	54.0
Domestic Institutions	7.9	7.0	6.7
FIIs/FDIs	21.0	20.6	20.9
Others	17.1	18.4	18.4

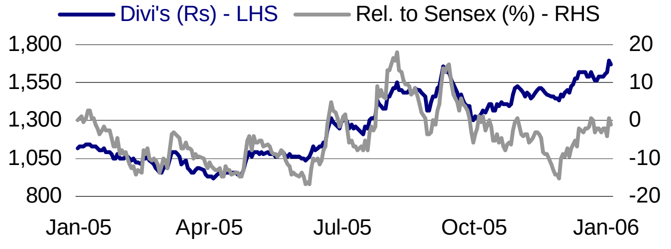
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	57.5	59.5	-3.4
FY07	65.1	73.6	-11.5

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,681	1,764	4.9	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)

Y/E MARCH	2004	2005	2006E	2007E	2008E
Net Sales	**3,028**	**3,474**	**3,779**	**4,537**	**5,228**
Change (%)	*22.8*	*14.7*	*8.8*	*20.1*	*15.2*
Total Expenditure	1,987	2,428	2,595	3,137	3,515
% of Sales	*65.6*	*69.9*	*68.7*	*69.1*	*67.2*
EBITDA	**1,041**	**1,046**	**1,185**	**1,400**	**1,713**
Margin (%)	*34.4*	*30.1*	*31.3*	*30.9*	*32.8*
Depreciation	132	151	149	250	287
EBIT	**909**	**895**	**1,035**	**1,150**	**1,426**
Int. and Finance Charges	34	43	73	140	122
Other Income - Rec.	145	171	103	183	207
PBT before EO Expense	1,020	1,024	1,065	1,193	1,511
Extra Ordinary Expense/(Income)		0	0	0	0
PBT after EO Expense	1,020	1,024	1,065	1,193	1,511
Current Tax	243	330	320	262	302
Deferred Tax	45	27	32	95	79
Tax Rate (%)	*28.2*	*34.9*	*33.0*	*30.0*	*25.2*
Reported PAT	**728**	**661**	**714**	**835**	**1,130**
PAT Adj for EO Items	**732**	**666**	**714**	**835**	**1,130**
Change (%)	*33.2*	*-9.0*	*7.1*	*17.0*	*35.4*
Margin (%)	*24.2*	*19.2*	*18.9*	*18.4*	*21.6*

RATIOS

Y/E MARCH	2004	2005	2006E	2007E	2008E
Basic (Rs)					
EPS	**28.5**	**52.0**	**55.7**	**65.1**	**88.2**
Cash EPS	33.7	63.7	67.3	84.6	110.6
BV/Share	89.4	221.3	266.7	322.1	397.1
DPS	8.0	8.0	10.3	9.7	13.2
Payout (%)	15.9	17.7	18.5	15.0	15.0
Valuation (x)					
P/E		32.3	30.2	25.8	19.1
Cash P/E		26.4	25.0	19.9	15.2
P/BV		7.6	6.3	5.2	4.2
EV/Sales		6.4	6.1	5.1	4.3
EV/EBITDA		21.2	19.5	16.5	13.2
Dividend Yield (%)		0.5	0.6	0.6	0.8
Return Ratios (%)					
RoE	36.9	26.0	22.8	22.1	24.5
RoCE	41.6	33.1	26.6	24.4	26.7
Working Capital Ratios					
Debtor (Days)	103	106	113	118	120
Creditor (Days)	154	156	148	151	156
Inventory (Days)	130	146	146	146	146
Working Capital Turnover (I	167	197	212	216	214
Leverage Ratio (x)					
Current Ratio	3.2	3.4	3.7	3.9	3.8
Debt/Equity	0.3	0.2	0.5	0.4	0.3

BALANCE SHEET (Rs Million)

Y/E MARCH	2004	2005	2006E	2007E	2008E
Equity Share Capital	128	128	128	128	128
Total Reserves	2,164	2,708	3,290	4,001	4,962
Net Worth	**2,292**	**2,837**	**3,419**	**4,129**	**5,090**
Deferred liabilities	223	250	282	378	456
Total Loans	659	661	1,653	1,708	1,297
Capital Employed	**3,174**	**3,748**	**5,354**	**6,215**	**6,843**
Gross Block	2,236	2,538	3,138	4,138	4,438
Less: Accum. Deprn.	573	723	872	1,122	1,409
Net Fixed Assets	**1,663**	**1,815**	**2,266**	**3,016**	**3,029**
Capital WIP	55	11	63	83	89
Investments	1	0	750	320	500
Curr. Assets	**2,115**	**2,717**	**3,119**	**3,764**	**4,366**
Inventory	1,076	1,390	1,512	1,815	2,091
Account Receivables	867	1,022	1,247	1,497	1,725
Cash and Bank Balance	72	45	77	111	158
Loans & Advances	100	260	283	340	392
Curr. Liability & Prov.	**660**	**795**	**844**	**968**	**1,140**
Account Payables	532	678	680	817	941
Provisions	128	117	164	151	199
Net Current Assets	**1,455**	**1,922**	**2,275**	**2,796**	**3,226**
Appl. of Funds	**3,174**	**3,748**	**5,354**	**6,215**	**6,843**

E: MOSt Estimates

CASH FLOW STATEMENT (Rs Million)

Y/E MARCH	2004	2005	2006E	2007E	2008E
Oper. Profit/(Loss) before T	1,041	1,046	1,185	1,400	1,713
Interest/Dividends Recd.	145	171	103	183	207
Direct Taxes Paid	-243	-330	-320	-262	-302
(Inc)/Dec in WC	-648	-493	-322	-486	-384
CF from Operations	**295**	**394**	**646**	**834**	**1,234**
EO Expense / (Income)	0	0	0	0	0
CF from Operating incl	**295**	**394**	**646**	**834**	**1,234**
(inc)/dec in FA	-340	-259	-652	-1,020	-306
(Pur)/Sale of Investments	0	1	-750	430	-180
CF from Investments	**-364**	**-263**	**-1,402**	**-590**	**-486**
Issue of Shares	0	1	0	0	0
(Inc)/Dec in Debt	225	2	992	55	-411
Interest Paid	-34	-43	-73	-140	-122
Dividend Paid	-116	-117	-132	-125	-169
Others	20	0	0	0	0
CF from Fin. Activity	**96**	**-158**	**788**	**-210**	**-702**
Inc/Dec of Cash	**27**	**-27**	**32**	**34**	**47**
Add: Beginning Balance	45	72	45	77	111
Closing Balance	**72**	**45**	**77**	**111**	**158**

NOTES

For more copies or other information, contact
Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari
Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

MOSt and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOSt has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

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

MOSt is not engaged in providing investment-banking services.

This information is subject to change without any prior notice. MOSt reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOSt is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.