Annual Report Update

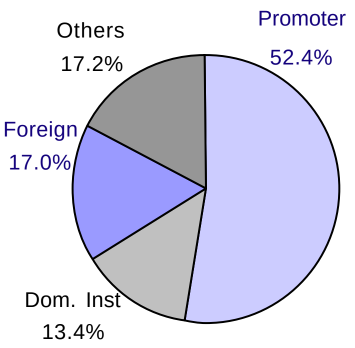
SECTOR: PHARMACEUTICALS

Divi's Laboratories

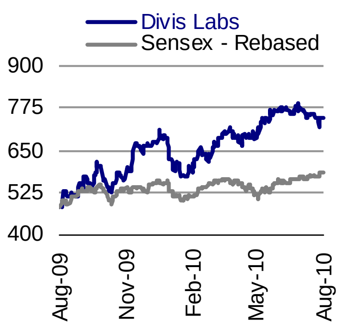
BSE SENSEX	S&P CNX
18,409	5,544

Bloomberg	DIVI IN
Reuters	DIVI.BO
Equity Shares (m)	132.1
52-Week Range	798/475
1,6,12 Rel. Perf. (%)	-5/12/34
M.Cap. (Rs b)	98.4
M.Cap. (US$ b)	2.1

SHAREHOLDING PATTERN % (JUN-10)



STOCK PERFORMANCE



Rs745 Buy

FY10 Annual Report Analysis

Inventory rationalization ends; Expect good growth across business segments

Divi's annual report for FY10 reinforces that inventory rationalization at the customers' end is more-or-less completed and that the company is likely to see good growth across business segments.

MD&A highlights

- **Innovators are increasing their dependence on cost-efficient sources:** The major factors causing sluggish growth in the global pharmaceuticals sector are patent expiration, slowdown in innovative product launches and hurdles imposed by players on market access and acceptance. In response to these factors, large pharma MNCs are pursuing M&A and are planning to expand presence in emerging markets, thereby increasing their dependence on cost-efficient sources for APIs.
- **Inventory rationalization is more-or-less over:** Divi's now visualizes that inventory rationalization is more or less completed by its customers and expects normalization of business across its markets, going forward.

Income statement and balance sheet highlights

- Though revenue and PAT declined 20% and 18%, respectively in FY10, Divi's reported highest ever cash flow from operations at Rs4.1b and highest ever free cash flow of Rs3.6b in its history.
- It spent very little on capex in FY10. The total capex for FY10 was Rs557m, towards enhancing production capacities.
- Cash and liquid investments increased by Rs2.7b to Rs4.6b in FY10. However, working capital cycle deteriorated from 167 days in FY09 to 204 days in FY10.

We continue to be positive on the prospects of pharma outsourcing from India, given the unique combination of low costs and chemistry skills that India offers. We expect Divi's to be a key beneficiary of the increased pharmaceutical outsourcing from India, given its strong relationships with global innovator companies. We estimate 25% topline CAGR over FY10-12, led mainly by a recovery in the CRAMS business (24% revenue CAGR) and 14% CAGR for the generic API business. Carotenoid supplies are likely to grow at 123% CAGR, though on a low base. EPS CAGR for FY10-12 will be 22% and lower than topline CAGR due to the expected increase in the tax rate for FY12. Based on our revised estimates, the stock trades at 24.4x FY11E and 19.6x FY12E earnings. Maintain **Buy** with a target price of Rs838.

Financial & valuation summary

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GR. (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/09A	11,803	4,166	32.2	19.5	23.2	7.8	39.6	40.6	8.4	19.1
03/10A	9,416	3,403	25.8	-19.9	28.9	6.5	24.7	27.3	10.5	24.3
03/11E	11,736	4,041	30.6	18.7	24.4	5.4	24.2	27.2	8.4	20.2
03/12E	14,599	5,032	38.1	24.5	19.6	4.5	25.2	29.7	6.7	15.6

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Divi's annual report focuses primarily on the factors driving its growth in the coming years

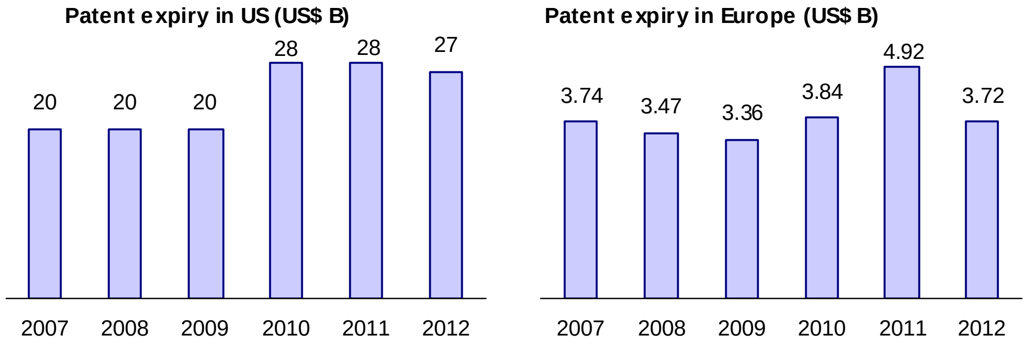
Divi's annual report focuses primarily on the factors driving its growth in the coming years. The management reiterated its positive stance on the overall CRAMS opportunity for companies like Divi's. It also indicated that inventory de-stocking at customers' end is almost over and that the company should see good growth in coming years. Further, the management talked about venturing into new areas.

Innovators are increasing their dependence on cost-efficient sources

The management attributes the muted growth expectation for the global pharmaceuticals industry to three major factors

The management attributed the muted growth rate expected by IMS for the global pharmaceuticals industry to three major factors: (1) Large Patent Expiries in regulated markets, (2) Decline in NCE approvals & falling R&D productivity and (3) Hurdles imposed by payers on market access and acceptance.

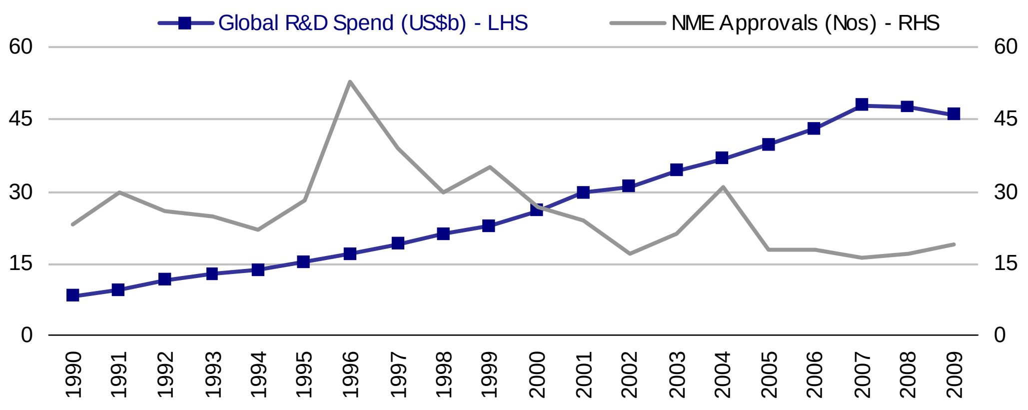
PATENT EXPIRIES IN REGULATED MARKETS TILL FY13 (US$96 B)



Source: Company/MOSL

DECLINE IN NCE APPROVALS & FALLING R&D PRODUCTIVITY

The growth strategies adopted by the pharma MNCs necessitate higher dependence on cost-efficient sources for active ingredients



Source: Company/MOSL

The management believes that the pharmaceuticals industry is not recession-proof but it is insulated to a greater extent than other industries, where spending is discretionary. In response to the above mentioned situations, large innovator companies have started adopting strategies like M&A, OTC growth, consumer product launches, and focus on emerging markets. These factors are increasing the dependence of large pharma MNCs on cost efficient sources for active ingredients.

Inventory rationalization is more or less over

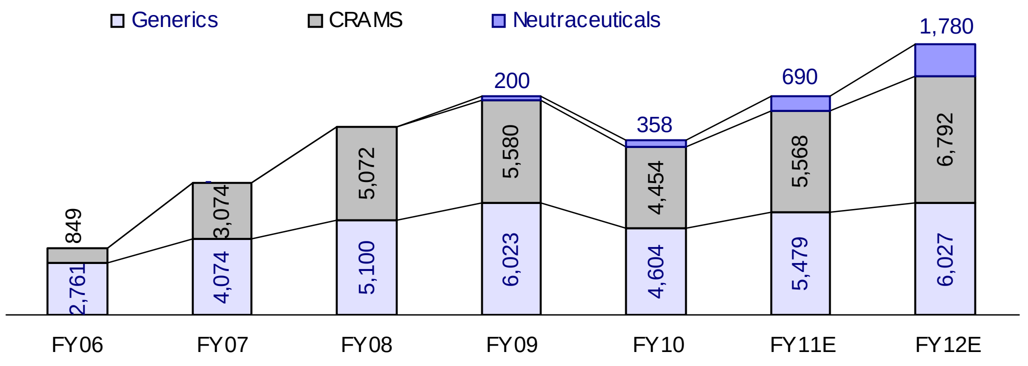
Divi's performance was adversely impacted by inventory de-stocking at the customers' end

Performance of the company and the CRAMS sector in general was adversely impacted by inventory de-stocking by innovator companies across supply chains, covering their plants, warehouses, distributors, stockists, and suppliers due to global economic slowdown.

The company has now indicated that inventory rationalization is more-or-less completed

Divi's has now indicated that inventory rationalization is more-or-less completed and it expects normalization of business across markets and better growth for itself in the coming years. We are projecting 25% revenue growth for the company in FY11.

REVENUE MIX



Source: Company/MOSL

Rs2b investment in new facilities

To tap new opportunities, Divi's is setting up of a new unit in its existing pharma SEZ

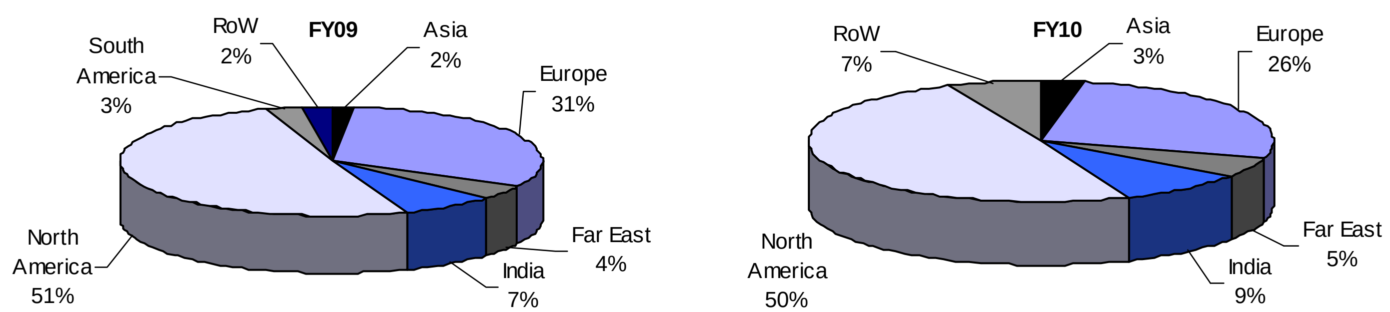
The company is in the process of setting up of a new unit in its existing pharma SEZ to tap new opportunities. It visualizes existing capacities nearing full utilization towards the end of the next financial year. The unit is likely to be completed by the end of 2011. The new opportunities are in the Hi-Potency and Steroids segments. Though Divi's has not disclosed the details of these opportunities, given its track record, we believe that the management is likely to have clear visibility of demand in these segments.

Focus remains on few products and regulated markets

The company continues to focus on launching few products but gaining significant market share in the launched products

The top product contributed 18% to total revenues, while the top-5 products contributed ~55% to total revenues in FY10. Some of these products command dominating market share globally. Divi's focuses on launching few products but gaining significant market share in the launched products. It derived 76% of sales from the regulated markets of US and Europe in FY10, down from 82% in FY09.

GEOGRAPHICAL BREAKUP



Source: Company/MOSL

Income statement and balance sheet highlights

Though revenue and PAT declined 20% and 18%, respectively in FY10, Divi's reported highest ever cash flow from operations at Rs4.1b and highest ever free cash flow of Rs3.6b in its history

- Divi's revenue for FY10 declined 20% to Rs9.4b due to inventory de-stocking undertaken by its customers. API revenues declined 24% to Rs4.6b while CRAMS revenues declined 20% YoY to Rs4.4b. However, Nutraceutical segment revenues almost doubled to Rs358m, albeit on a low base.
- Though gross margin improved 60bp to 52.1%, EBITDA margin declined 90bp to 43% on account of operating deleverage.
- PAT declined 18% to Rs3.4b, reflecting the overall slowdown in revenues.
- Though Divi's revenue and PAT declined 20% and 18%, respectively in FY10, the company reported highest-ever cash flows from operations at Rs4.1b and highest-ever free cash flow of Rs3.6b in its history.
- The company spent very little on capex in FY10. The total capex for FY10 stood at Rs557m, towards enhancing production capacities.
- Cash and liquid investments increased by Rs2.7b to Rs4.6b during the year.
- Working capital cycle deteriorated from 167 days in FY09 to 204 days in FY10. Inventory increased from 130 days in FY09 to 193 days in FY10, due to lean inventory management by customers.

Management guides revenue growth of 25-30% for FY11

Divi's management guided that customer inventory de-stocking has ended and CRAMS outsourcing has resumed. We note that there has been no major adverse impact on the demand for pharmaceutical products due to global economic slowdown. The long-term prospects for outsourcing are strong.

FY11 GUIDANCE

PARAMETER	GUIDANCE	REMARKS
Topline (Rs b)	12	Recovery in CRAMS business and ramp-up in Neutraceuticals coupled with new API launches to drive top-line growth. We estimate FY11E top-line growth of 24.6% at Rs11.7b.
EBITDA Margins (%)	43	Management has guided sustaining EBITDA margins at FY10 levels of 43%. We estimate 41.5% margins
Capex (Rs b)	2	Resumption of capex implies up-tick in customer sourcing

Source: Company/MOSL

Valuation and view

We remain positive on the prospects of pharma outsourcing from India; maintain our Buy rating on Divi's

We continue to be positive on the prospects of pharma outsourcing from India, given the unique combination of low costs and chemistry skills that India offers. We expect Divi's to be a key beneficiary of the increased pharmaceutical outsourcing from India, given its strong relationships with global innovator companies. We estimate 25% topline CAGR over FY10-12, led mainly by a recovery in the CRAMS business (24% revenue CAGR) and 14% CAGR for the generic API business. Carotenoid supplies are likely to grow at 123% CAGR, though on a low base. EPS CAGR for FY10-12 will be 22% and lower than topline CAGR due to the expected increase in the tax rate for FY12. Based on our revised estimates, the stock trades at 24.4x FY11E and 19.6x FY12E earnings. Maintain **Buy** with a target price of Rs838.

Financials and Valuation

INCOME STATEMENT					(Rs Million)
Y/E MARCH	2008	2009	2010	2011E	2012E
Net Sales	**10,328**	**11,803**	**9,416**	**11,736**	**14,599**
Change (%)	*42.6*	*14.3*	*-20.2*	*24.6*	*24.4*
Total Expenditure	6,127	6,625	5,364	6,862	8,316
% of Sales	*59.3*	*56.1*	*57.0*	*58.5*	*57.0*
EBITDA	**4,201**	**5,178**	**4,053**	**4,875**	**6,283**
Margin (%)	*40.7*	*43.9*	*43.0*	*41.5*	*43.0*
Depreciation	357	479	515	637	768
EBIT	**3,845**	**4,700**	**3,538**	**4,238**	**5,515**
Int. and Finance Charges	102	72	28	27	26
Other Income - Rec.	32	-145	343	382	501
PBT before EO Expense	3,775	4,482	3,853	4,592	5,990
Extra Ordinary Expense/(Inc	0	0	0	0	0
PBT after EO Expense	3,775	4,482	3,853	4,592	5,990
Current Tax	194	266	408	551	958
Deferred Tax	105	50	42	0	0
Tax Rate (%)	*7.9*	*7.0*	*11.7*	*12.0*	*16.0*
Reported PAT	**3,476**	**4,166**	**3,403**	**4,041**	**5,032**
PAT Adj for EO Items	**3,476**	**4,166**	**3,403**	**4,041**	**5,032**
Change (%)	*81.1*	*19.9*	*-18.3*	*18.7*	*24.5*
Margin (%)	*33.7*	*35.3*	*36.1*	*34.4*	*34.5*

RATIOS					
Y/E MARCH	2008	2009	2010	2011E	2012E
Basic (Rs)					
EPS	**26.9**	**32.2**	**25.8**	**30.6**	**38.1**
Cash EPS	29.7	35.9	29.7	35.4	43.9
BV/Share	66.7	95.8	114.9	137.4	165.1
DPS	2.0	3.0	6.0	6.9	8.9
Payout (%)	8.7	10.9	27.2	26.3	27.3
Valuation (x)					
P/E	27.7	23.2	28.9	24.4	19.6
Cash P/E	25.1	20.8	25.1	21.0	17.0
P/BV	11.2	7.8	6.5	5.4	4.5
EV/Sales	9.6	8.4	10.5	8.4	6.7
EV/EBITDA	23.6	19.1	24.3	20.2	15.6
Dividend Yield (%)	0.3	0.4	0.8	0.9	1.2
Return Ratios (%)					
RoE	49.5	39.6	24.7	24.2	25.2
RoCE	47.2	40.6	27.3	27.2	29.7
Working Capital Ratios					
Fixed Asset Turnover (x)	2.4	2.2	1.6	1.8	2.0
Debtor (Days)	74	82	88	93	93
Inventory (Days)	99	130	193	164	164
Working Capital Turnover (I	126	167	204	192	190
Leverage Ratio (x)					
Current Ratio	2.9	3.6	3.1	3.4	3.3
Debt/Equity	0.1	0.0	0.0	0.0	0.0

BALANCE SHEET					(Rs Million)
Y/E MARCH	2008	2009	2010	2011E	2012E
Equity Share Capital	258	259	264	264	264
Total Reserves	8,356	12,155	14,914	17,892	21,552
Net Worth	**8,614**	**12,414**	**15,178**	**18,156**	**21,817**
Deferred liabilities	383	432	474	474	474
Total Loans	861	526	328	290	290
Capital Employed	**9,857**	**13,372**	**15,981**	**18,920**	**22,581**
Gross Block	6,422	7,828	8,329	10,107	11,607
Less: Accum. Deprn.	1,451	1,929	2,431	3,163	3,931
Net Fixed Assets	**4,971**	**5,899**	**5,898**	**6,944**	**7,676**
Capital WIP	631	195	238	195	195
Investments	556	1,718	4,413	5,213	6,713
Curr. Assets	**5,630**	**7,671**	**8,040**	**9,329**	**11,508**
Inventory	2,814	4,213	4,985	5,281	6,570
Account Receivables	2,095	2,660	2,232	2,934	3,650
Cash and Bank Balance	142	148	165	410	413
Loans & Advances	579	650	658	704	876
Curr. Liability & Prov.	**1,930**	**2,110**	**2,608**	**2,761**	**3,511**
Account Payables	1,564	1,621	1,643	1,643	2,044
Provisions	366	489	964	1,118	1,467
Net Current Assets	**3,700**	**5,561**	**5,432**	**6,568**	**7,997**
Appl. of Funds	**9,857**	**13,372**	**15,981**	**18,920**	**22,581**

E: MOSL Estimates

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2008	2009	2010	2011E	2012E
Op.Profit/(Loss) bef. Tax	4,201	5,178	4,053	4,875	6,283
Interest/Dividends Recd.	32	-145	343	382	501
Direct Taxes Paid	-194	-266	-408	-551	-958
(Inc)/Dec in WC	-675	-1,855	145	-891	-1,426
CF from Operations	**3,365**	**2,912**	**4,133**	**3,814**	**4,401**
EO Expense / (Income)	0	0	0	0	0
CF from Operations in	**3,365**	**2,912**	**4,133**	**3,814**	**4,401**
(inc)/dec in FA	-1,764	-971	-557	-1,640	-1,500
(Pur)/Sale of Investments	-550	-1,162	-2,695	-800	-1,500
CF from Investments	**-2,314**	**-2,133**	**-3,252**	**-2,440**	**-3,000**
Change in networth	20	89	285	0	0
Inc/(Dec) in Debt	-679	-334	-198	-38	0
Interest Paid	-102	-72	-28	-27	-26
Dividend Paid	-302	-456	-925	-1,063	-1,371
Others	-18	0	0	0	0
CF from Fin. Activity	**-1,081**	**-773**	**-865**	**-1,129**	**-1,398**
Inc/Dec of Cash	**-30**	**6**	**17**	**245**	**3**
Add: Beginning Balance	172	142	148	165	410
Closing Balance	**142**	**148**	**165**	**410**	**413**

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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