MOTILAL OSWAL

Divi's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 19,243	DIVI IN
	REUTERS CODE
S&P CNX: 5,702	DIVI.BO

Equity Shares (m)	64.6
52-Week Range	1,662/472
1,6,12 Rel. Perf. (%)	23/93/171
M.Cap. (Rs b)	106.3
M.Cap. (US$ b)	2.7

27 October 2007

Neutral

Previous Recommendation: Neutral

Rs1,647

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
03/07A	7,244	1,919	29.7	172.1	55.4	19.6	43.5	40.0	14.9	43.8
03/08E	10,024	3,201	49.6	66.8	33.2	13.3	47.8	46.0	10.7	26.5
03/09E	12,130	3,879	60.1	21.2	27.4	9.6	40.7	41.2	8.7	22.0

Divi’s Labs 2QFY08 performance was above estimates. Key highlights:

- Net sales grew by 50% to Rs2.4b (vs estimate of Rs2.1b) while PAT grew by 191% to Rs913m (vs estimate of Rs600m). The generics and custom chemical synthesis (CCS) business each contributed 50% of revenues. Divi’s has been able to report higher growth despite the significant currency appreciation. Exports contributed over 90% of revenues.
- We believe that the increase in business is due to higher growth in sales to innovator companies for the CCS business and increase in sales of its existing generic products. EBITDA margins improved by 1640bp to 43%, mainly due to higher CCS sales (which attract better margins). PAT was partly boosted by higher top-line growth, improved product-mix and lower tax provision arising from its EoU and SEZ facilities.
- Based on the better than expected performance, we have increased our EPS estimates for FY08E and FY09E by 20% and 18.5% respectively.

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 are extremely positive on Divi’s future prospects, rich valuations have tempered down our optimism. Based on our revised estimates, Divi’s is valued at 33.2x FY08E and 27.4x FY09E earnings. We maintain **Neutral** rating.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY07				FY08				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Op Revenue	**1,608**	**1,614**	**1,496**	**2,526**	**2,281**	**2,425**	**2,406**	**2,912**	**7,244**	**10,024**
YoY Change (%)	*148.8*	*98.3*	*38.6*	*98.8*	*41.8*	*50.3*	*60.8*	*15.3*	*90.1*	*38.4*
Total Expenditure	1,148	1,179	1,071	1,387	1,438	1,375	1,518	1,633	4,784	5,964
EBITDA	**461**	**435**	**425**	**1,139**	**843**	**1,050**	**887**	**1,279**	**2,460**	**4,059**
Margins (%)	*28.6*	*26.9*	*28.4*	*45.1*	*36.9*	*43.3*	*36.9*	*43.9*	*34.0*	*40.5*
Depreciation	43	42	59	80	86	78	85	89	223	338
Interest	21	6	38	41	34	32	42	58	106	166
Other Income	44	34	25	34	34	15	17	15	136	82
PBT	**441**	**421**	**353**	**1,052**	**757**	**956**	**777**	**1,147**	**2,267**	**3,637**
Tax	167	114	-1	54	49	1	93	293	334	436
Deferred Tax	6	-6	27	-14	36	42	0	-78	14	0
Rate (%)	*39.4*	*25.7*	*7.3*	*3.8*	*11.1*	*4.5*	*12.0*	*18.8*	*15.3*	*12.0*
Adj PAT	**267**	**313**	**327**	**1,012**	**673**	**913**	**684**	**931**	**1,919**	**3,201**
YoY Change (%)	*109.6*	*96.2*	*73.2*	*341.9*	*151.6*	*191.7*	*109.0*	*-7.9*	*172.3*	*66.8*
Margins (%)	*16.6*	*19.4*	*21.9*	*40.0*	*29.5*	*37.6*	*28.4*	*32.0*	*26.5*	*31.9*

E: MOSt Estimates

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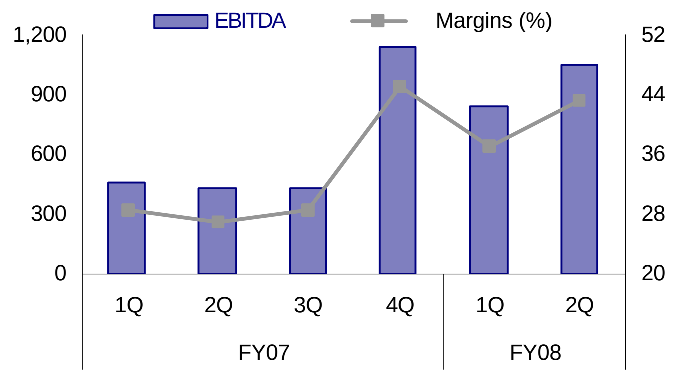
Significant growth in both generics and CCS businesses

Net sales during the quarter grew by 50% to Rs2.4b, based on significant growth in both the generics and custom chemical synthesis (CCS) business (not quantified). Both these businesses contribute equally to the top-line. The increase in business is due to significant growth in sales to innovator companies for the CCS business and higher traction in generics sales. 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 CCS sales expand EBITDA margins

EBITDA margins expanded significantly by 1640bp to 43% compared to 26.9% in 2QFY07 led mainly by higher CCS revenues. We believe that margins would have been still better, had it not been for the 10% currency appreciation vis-à-vis the US$.

TREND IN EBITDA (RS M)



Source: Company/Motilal Oswal Securities

Lower tax also help boosts PAT

PAT for the quarter grew by 191% to Rs913m, boosted by higher top-line growth and partly by tax savings. The company had converted one of its existing units into an EoU with effect from 01-Jun-06 and has also commissioned the first phase of its new SEZ unit on 27-Oct-06. Sales from these units enjoy tax exemption resulting in effective tax rate of 4.5% for the quarter compared to 25.7% for 2QFY07. The company has guided for an overall effective tax rate of 12% for FY08E.

Generics business: Global M&A leads to significant traction

Divi's enjoys leadership in some of its generic products, viz., Naproxen, Diltiazem and Dextromethorphan (together accounting for about 40-50% of FY07 sales). 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, Divi's is witnessing significant growth in its generics business (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. The company has also been able to commercialize some new API generics (details not disclosed). This has boosted Divi's generic revenues in 2QFY08.

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 these products in a phased manner from FY09E onwards.

CCS business: to expand in the coming years

Divi's CCS business contributed about 50% of its turnover in 2QFY08. 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).

The traction in the CCS business is being 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 DSM 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 has set up the required facilities for converting 100% pure carotenoids in to granules (beadlet technology) which can be used by its customers directly. Supplies are likely to commence in 2HFY08E post receipt of regulatory approvals. We estimate supplies worth $10-12m (~ 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 has (in Oct-06) commissioned the first phase of its new API unit at Vizag (AP) with SEZ status at a capex of Rs3b spread over the next few years. It has spent 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-Oct-06 and has commenced contributing to revenues from 4QFY07 onwards, while the full benefits of the capacity expansion are likely to be visible in FY08E.

Scientist strength to double in FY06-08 period

Divi's has enhanced its scientist strength significantly in the last one year to about 200 compared to 125 for FY06. It is likely to go up further to about 250 in FY08 implying a doubling of scientists. We view this as a long-term positive as it will permit the company to work on higher CCS projects.

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/neutraceuticals business.

Generic business growth likely to be more gradual in FY09E

Divi's generics business has been witnessing exponential growth in FY07-08 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 was a one-time phenomenon and growth is likely to revert back to the more gradual 8-10% 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.

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 RoCE of over 40% for the next two years. We expect pharmaceutical outsourcing to gain traction from FY09E onwards, 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 are extremely positive on Divi's future prospects, rich valuations have tempered down our optimism. Divi's is currently valued at 33.2x FY08E and 27.4x FY09E earnings. We maintain **Neutral** with a price target of Rs1,502.

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 in Oct-2006.

Valuation and view

- Revenue and Earnings CAGR of 29% and 42% expected over FY07-FY09E.
- Valuations at 33.2x FY08E and 27.4x FY09E are rich.

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	DISHMAN
P/E (x)	FY08E	33.2	21.4	21.2
	FY09E	27.4	18.5	16.0
P/BV(x)	FY08E	13.3	4.8	5.1
	FY09E	9.6	4.1	3.9
EV/Sales(x)	FY08E	10.7	2.4	3.7
	FY09E	8.7	2.2	3.0
EV/EBITDA(x)	FY08E	26.5	14.9	17.9
	FY09E	22.0	12.9	13.7

EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	49.6	35.8	38.5
FY09	60.1	45.6	31.6

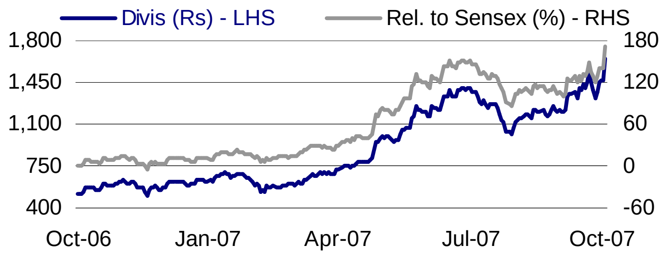
TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,647	1,502	-	Neutral

SHAREHOLDING PATTERN (%)

	SEP-07	JUN-07	SEP-06
Promoter	53.5	53.5	53.9
Domestic Inst	12.1	14.0	11.2
Foreign	18.1	15.3	16.9
Others	16.3	17.2	18.0

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)

Y/E MARCH	2005	2006	2007	2008E	2009E
Net Sales	**3,474**	**3,811**	**7,244**	**10,024**	**12,130**
Change (%)	*14.7*	*9.7*	*90.1*	*38.4*	*21.0*
Total Expenditure	2,428	2,644	4,784	5,964	7,318
% of Sales	*69.9*	*69.4*	*66.0*	*59.5*	*60.3*
EBITDA	**1,046**	**1,167**	**2,460**	**4,059**	**4,811**
Margin (%)	*30.1*	*30.6*	*34.0*	*40.5*	*39.7*
Depreciation	151	148	223	338	402
EBIT	**895**	**1,019**	**2,237**	**3,721**	**4,409**
Int. and Finance Charges	43	56	106	166	179
Other Income - Rec.	171	106	136	82	178
PBT before EO Expense	1,024	1,069	2,267	3,637	4,408
Extra Ordinary Expense/(Inc	0	0	0	0	0
PBT after EO Expense	1,024	1,069	2,267	3,637	4,408
Current Tax	330	338	334	436	529
Deferred Tax	27	31	14	0	0
Tax Rate (%)	*34.9*	*34.5*	*15.3*	*12.0*	*12.0*
Reported PAT	**661**	**705**	**1,917**	**3,201**	**3,879**
PAT Adj for EO Items	**666**	**700**	**1,919**	**3,201**	**3,879**
Change (%)	*-9.0*	*5.1*	*174.0*	*66.8*	*21.2*
Margin (%)	*19.2*	*18.4*	*26.5*	*31.9*	*32.0*

BALANCE SHEET (Rs Million)

Y/E MARCH	2005	2006	2007	2008E	2009E
Equity Share Capital	128	128	129	129	129
Total Reserves	2,708	3,280	5,291	7,852	10,955
Net Worth	**2,837**	**3,408**	**5,420**	**7,981**	**11,084**
Deferred liabilities	250	282	295	295	295
Total Loans	661	1,502	1,540	1,586	1,591
Capital Employed	**3,748**	**5,192**	**7,255**	**9,863**	**12,971**
Gross Block	2,538	3,019	4,907	5,907	6,907
Less: Accum. Deprn.	723	871	1,095	1,433	1,835
Net Fixed Assets	**1,815**	**2,148**	**3,812**	**4,474**	**5,072**
Capital WIP	11	803	382	118	138
Investments	0	4	6	400	400
Curr. Assets	**2,717**	**3,546**	**4,314**	**7,359**	**10,373**
Inventory	1,390	1,839	2,100	3,007	3,639
Account Receivables	1,022	1,074	1,645	3,308	4,003
Cash and Bank Balance	45	101	172	443	2,004
Loans & Advances	260	532	397	601	728
Curr. Liability & Prov.	**795**	**1,309**	**1,259**	**2,488**	**3,012**
Account Payables	668	1,152	1,239	1,804	2,183
Provisions	127	158	19	684	829
Net Current Assets	**1,922**	**2,237**	**3,055**	**4,871**	**7,361**
Appl. of Funds	**3,748**	**5,192**	**7,255**	**9,863**	**12,971**

E: MOSt Estimates

RATIOS

Y/E MARCH	2005	2006	2007	2008E	2009E
Basic (Rs)					
EPS	**10.4**	**10.9**	**29.7**	**49.6**	**60.1**
Cash EPS	12.7	13.2	33.2	54.8	66.3
BV/Share	44.3	53.2	84.0	123.6	171.7
DPS	8.0	10.0	2.0	8.7	10.5
Payout (%)	17.7	20.7	7.7	20.0	20.0
Valuation (x)					
P/E		150.7	55.4	33.2	27.4
Cash P/E		124.4	49.6	30.0	24.8
P/BV		31.0	19.6	13.3	9.6
EV/Sales		28.3	14.9	10.7	8.7
EV/EBITDA		92.3	43.8	26.5	22.0
Dividend Yield (%)		0.6	0.1	0.5	0.6
Return Ratios (%)					
RoE	26.0	22.4	43.5	47.8	40.7
RoCE	33.1	26.8	40.0	46.0	41.2
Working Capital Ratios					
Debtor (Days)	107	103	83	120	120
Creditor (Days)	70	110	62	66	66
Inventory (Days)	146	176	106	110	110
Working Capital Turnover (I	197	205	145	161	161
Leverage Ratio (x)					
Current Ratio	3.4	2.7	3.4	3.0	3.4
Debt/Equity	0.2	0.4	0.3	0.2	0.1

CASH FLOW STATEMENT (Rs Million)

Y/E MARCH	2005	2006	2007	2008E	2009E
Op.Profit/(Loss) bef. Tax	1,046	1,167	2,460	4,059	4,811
Interest/Dividends Recd.	171	106	136	82	178
Direct Taxes Paid	-330	-338	-334	-436	-529
(Inc)/Dec in WC	-493	-259	-747	-1,545	-929
CF from Operations	**394**	**677**	**1,515**	**2,159**	**3,531**
EO Expense / (Income)	0	0	0	0	0
CF from Operating incl	**394**	**677**	**1,515**	**2,159**	**3,531**
(inc)/dec in FA	-259	-1,272	-1,467	-736	-1,020
(Pur)/Sale of Investments	1	-4	-2	-394	0
CF from Investments	**-258**	**-1,276**	**-1,469**	**-1,130**	**-1,020**
Issue of Shares	1	13	242	0	0
(Inc)/Dec in Debt	2	841	38	47	5
Interest Paid	-43	-56	-106	-166	-179
Dividend Paid	-117	-146	-147	-640	-776
Others	-5	4	-2	0	0
CF from Fin. Activity	**-163**	**656**	**25**	**-759**	**-950**
Inc/Dec of Cash	**-27**	**56**	**70**	**270**	**1,561**
Add: Beginning Balance	72	45	101	172	443
Closing Balance	**45**	**101**	**172**	**443**	**2,004**

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