

2Q in line; Maintain Underperform

2Q PAT declined 37% yoy; Maintain Underperform

Divis' 2Q PAT of Rs848mn (down 37% yoy) was in line with our estimates despite 32% decline in revenues (Rs2.3bn, 24% below BofA-MLe). This was largely due to much stronger EBITDA margins of 47% (vs 35% est.) on rich product mix. We retain our forecasts but revise our PO to Rs490, based SOTP of core business at Rs440 (at 15x FY11E, in line with peers) and NPV for Nutraceuticals business at Rs50 (vs Rs75 earlier). Maintain Underperform on rich valuations.

2Q margins not sustainable; Revenue visibility weak

Divis' 2Q EBITDA margin at 47% was largely due to shift product mix in favour of selected high margin products. However, long term margins would sustain at 38-39% levels only as overall product mix would normalize. Revenue growth however would continue to be affected by inventory destocking at clients end till 3Q atleast. We forecast weak 9% revenue CAGR (FY09-12E) on poor visibility.

Nutraceuticals business to be long term opportunity

Having launched eight nutraceuticals products under the "Vivital" brand in 1Q last year, carotenoids business contributed ~Rs250mn revenues in FY09. We estimate this scale-up to US\$18-20mn p.a. by FY12E. We value the Nutraceuticals business on NPV basis at Rs50/sh (US\$130mn) vs Rs75/sh earlier on slower sales pickup.

Valuations expensive; lack of upside triggers

Divis trades at 24x FY10E and 16x FY11E (core EPS), ~10% premium to sector average. We find current valuations rich on account of relatively low revenue visibility and lack of upside triggers. An earlier than expected business recovery is key risk to our rating.

Estimates (Mar)

(Rs)	2008A	2009A	2010E	2011E	2012E
Net Income (Adjusted - mn)	3,536	4,244	3,088	3,828	4,721
EPS	27.08	32.77	23.65	29.32	36.16
EPS Change (YoY)	88.2%	21.0%	-27.8%	24.0%	23.3%
Dividend / Share	0.989	3.00	2.98	2.98	2.98
Free Cash Flow / Share	13.51	16.87	19.17	28.45	31.81

Valuation (Mar)

	2008A	2009A	2010E	2011E	2012E
P/E	19.69x	16.27x	22.55x	18.19x	14.75x
Dividend Yield	0.185%	0.562%	0.558%	0.558%	0.558%
EV / EBITDA*	15.86x	13.57x	17.16x	13.91x	11.45x
Free Cash Flow Yield*	2.53%	3.14%	3.59%	5.33%	5.96%
EV/Sales	6.61x	5.74x	6.37x	5.31x	4.43x

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

Bank of America Merrill Lynch

Arvind Bothra >> +91 22 6632 8685
Research Analyst
DSP Merrill Lynch (India)
arvind.bothra@baml.com

S.Arun >> +91 22 6632 8657
Research Analyst
DSP Merrill Lynch (India)
s.arun@baml.com

Stock Data

Price	Rs533.35
Price Objective	Rs490.00
Date Established	1-Nov-2009
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs377.50-Rs684.00
Mrkt Val / Shares Out (mn)	US\$1,475 / 130.6
Average Daily Volume	583,979
ML Symbol / Exchange	XXQPF / BSE
Bloomberg / Reuters	DIVI IN / DIVI.BO
ROE (2010E)	22.8%
Net Dbt to Eqty (Mar-2009A)	3.0%
Est. 5-Yr EPS / DPS Growth	18.0% / 0%
Free Float	46.0%

Key Changes

(Rs)	Previous	Current
Price Obj.	442.00	490.00
2010E EPS	23.84	23.65
2011E EPS	29.36	29.32
2012E EPS	36.45	36.16

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iQprofileSM Divi's Lab

Key Income Statement Data (Mar)	2008A	2009A	2010E	2011E	2012E
(Rs Millions)					
Sales	10,468	12,035	10,836	12,971	15,536
Gross Profit	5,201	6,193	5,026	6,148	7,446
Sell General & Admin Expense	(634)	(859)	(777)	(913)	(1,095)
Operating Profit	3,949	4,555	3,417	4,269	5,249
Net Interest & Other Income	(102)	29	48	107	146
Associates	NA	NA	NA	NA	NA
Pretax Income	3,847	4,583	3,465	4,375	5,395
Tax (expense) / Benefit	(311)	(339)	(377)	(547)	(674)
Net Income (Adjusted)	3,536	4,244	3,088	3,828	4,721
Average Fully Diluted Shares Outstanding	131	130	131	131	131

Key Cash Flow Statement Data

Net Income	3,536	4,244	3,088	3,828	4,721
Depreciation & Amortization	357	478	561	642	712
Change in Working Capital	(767)	(1,855)	51	(140)	(737)
Deferred Taxation Charge	118	73	56	66	81
Other Adjustments, Net	282	214	227	318	376
Cash Flow from Operations	3,525	3,155	3,982	4,714	5,153
Capital Expenditure	(1,761)	(970)	(1,480)	(1,000)	(1,000)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	(556)	(1,162)	(1,281)	(2,830)	(3,193)
Cash Flow from Investing	(2,317)	(2,132)	(2,761)	(3,830)	(4,193)
Shares Issue / (Repurchase)	0	0	132	0	0
Cost of Dividends Paid	(129)	(389)	(389)	(389)	(389)
Cash Flow from Financing	(1,249)	(1,017)	(1,076)	(825)	(890)
Free Cash Flow	1,764	2,185	2,502	3,714	4,153
Net Debt	719	379	227	107	(18)
Change in Net Debt	(637)	(340)	(151)	(121)	(124)

Key Balance Sheet Data

Property, Plant & Equipment	5,601	6,094	7,012	7,370	7,658
Other Non-Current Assets	556	1,718	2,999	5,829	9,021
Trade Receivables	2,095	2,660	2,642	2,818	3,382
Cash & Equivalents	142	148	294	352	423
Other Current Assets	3,394	4,863	5,020	5,319	5,960
Total Assets	11,787	15,483	17,966	21,689	26,444
Long-Term Debt	861	526	521	459	405
Other Non-Current Liabilities	383	432	441	450	459
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	1,930	2,110	2,300	2,635	3,103
Total Liabilities	3,173	3,069	3,261	3,544	3,967
Total Equity	8,614	12,414	14,705	18,145	22,477
Total Equity & Liabilities	11,787	15,483	17,966	21,689	26,444

iQmethodSM - Bus Performance*

Return On Capital Employed	41.7%	36.1%	21.5%	22.3%	22.4%
Return On Equity	50.6%	40.4%	22.8%	23.3%	23.2%
Operating Margin	38.2%	38.3%	31.9%	33.2%	34.0%
EBITDA Margin	41.1%	41.8%	36.7%	37.9%	38.4%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.0x	0.7x	1.3x	1.2x	1.1x
Asset Replacement Ratio	4.9x	2.0x	2.6x	1.6x	1.4x
Tax Rate (Reported)	8.1%	7.4%	10.9%	12.5%	12.5%
Net Debt-to-Equity Ratio	8.3%	3.0%	1.5%	0.6%	-0.1%
Interest Cover	38.8x	NM	NM	NM	NM

Key Metrics

Sales Growth (YoY)	42.6%	15.2%	-10.0%	20.0%	20.0%
EBITDA Growth (YoY)	73.0%	16.9%	-21.0%	23.4%	21.4%
Net Income Growth (YoY)	90.2%	20.0%	-27.2%	24.0%	23.3%
Net Profit Margin	33.8%	35.3%	28.5%	29.5%	30.4%

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

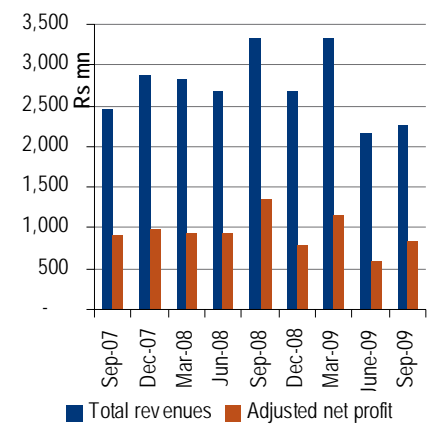
Company Description

Divi's Labs is positioned in the US\$25bn global pharmaceutical outsourcing market as a research-focused custom manufacturing player (bulk drugs/intermediates). About 48% of Divi's revenues (FY09) 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.

Investment Thesis

We believe the impact of inventory destocking at customers end will impact revenue visibility for Divi's in the near term. We expect recovery to take time and to likely affect the company's historical growth trajectory. While business fundamentals remain intact, concerns on topline can be expected to put pressure. We expect the stock to Underperform in the light of weaker outlook and expensive valuations.

Chart 1: Quarterly Sales and Profit trends



Source: Company

Stock Data

Price to Book Value	4.7x
Market Cap (US\$ mn)	1,475

2QFY10 Result Variance analysis

Table 1: Divi's Quarterly, March fiscal year-ends (Rs mn)

Year to Mar (Rs mn)	2QFY09	1QFY10	2QFY10	YoY %	QoQ%	Comments
Net Sales	3,305	2,058	2,253	-32%	9%	Sharp 32% decline in topline, 24% below our estimates despite currency benefit. Impact of inventory destocking continues sharper than expectations and will likely continue till 3QFY10 atleast
Other operating income	26	117	21	-18%	-82%	
Total income	3,331	2,175	2,275	-32%	5%	Custom synthesis comprised nearly ~49% of the turnover
Raw material consumed	1,062	851	644	-39%	-24%	Gross margin expansion attributed to richer product mix, driven by increased offtake of selected high margin products
as a % of Total income	32%	39%	28%	(360bps)	(1,081bps)	
Staff cost	170	192	177	4%	-8%	Reflects effect of pay increase effective from Jan-09, however, higher lower than 1Q, to sustain at similar levels
as a % of Total income	5%	9%	8%	266bps	(106bps)	
Manufacturing expenses	181	172	183	1%	6%	Lower operating leverage as fixed costs as a % of revenues increase
as a % of Total income	5%	8%	8%	260bps	12bps	
Other Expenses	313	177	198	-37%	11%	Included -Rs5mn towards forex fluctuations and forward contracts MTM losses in 2QFY10, against Rs35mn last year
as a % of Total income	9%	8%	9%	(71bps)	53bps	
Total Expenditure	1,726	1,392	1,200	-30%	-14%	
Operating profit	1,605	784	1,074	-33%	37%	Decline largely owing to lower sales
OPM (%)	48%	36%	47%	(95bps)	1,121bps	EBITDA margins beat our estimate of 35% due to higher gross margins on better product mix
Interest (net)	(18)	(8)	(30)	64%	264%	
Depreciation	(119)	(129)	(131)	9%	1%	Fully operational Vizag SEZ and carotenoids plant, in line with last 3 quarters
Pre-tax profits	1,491	132	947	-36%	617%	PBT in line despite lower sales due to higher margins
Extraordinary items		(540)	-	N.A	N.A	Amendment in SEZ Act, leading to provision for higher income tax prospectively from April'06 to March'09, now provided for in 1QFY10
Tax	(137)	(89)	(100)	-28%	11%	Tax rate likely to increase from -8% now to 12% as MAT rates have increased (from 10% to 15%)
Net profits (reported)	1,354	43	848	-37%	1876%	
Adjusted net profits	1,354	583	848	-37%	45%	Adjusted PAT for 2QFY10 is in line with our estimate, largely due to higher margins

Source: BofA-Merrill Lynch Research, Company

Price objective basis & risk

Divi's Lab (XXQPF)

Our PO of Rs490 is based on SoTP which includes Rs440/sh for the base business and Rs50/sh for nutraceuticals (carotenoids). In our view, Divis' should trade in line with mid-cap pharma sector average multiple (15x on FY11E EPS) given weaker revenue visibility.

Upside risks: (a) Impact of one-off sales and lumpiness in business, (b) lesser impact of inventory destocking leading to earlier than expected recovery of business. Downside risks: (a) Global slowdown to impact sales further, and prolong recovery, and (b) nutraceuticals business does not ramp up as expected.

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Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
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	CADILA HEALTHCAR	CDLHF	CDH IN	Arvind Bothra
	Dr Reddy's Lab	DRYBF	DRRD IN	S.Arun
	Dr Reddys Lab-A	RDY	RDY US	S.Arun
	Glenmark Pharm	XVQWF	GNP IN	Arvind Bothra
	Lupin Limited	LPMCF	LPC IN	S.Arun
NEUTRAL	GSK India	GXOLF	GLXO IN	Arvind Bothra

India - Healthcare Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
UNDERPERFORM				
	Divi's Lab	XXQPF	DIVI IN	Arvind Bothra
	Piramal Healthcare Ltd	XNIGF	PIHC IN	Arvind Bothra
RSTR				
	Sun Pharma	SPCEF	SUNP IN	S.Arun
RVW				
	Panacea Biotech	XPEAF	PNCB IN	Arvind Bothra

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 Amortization
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

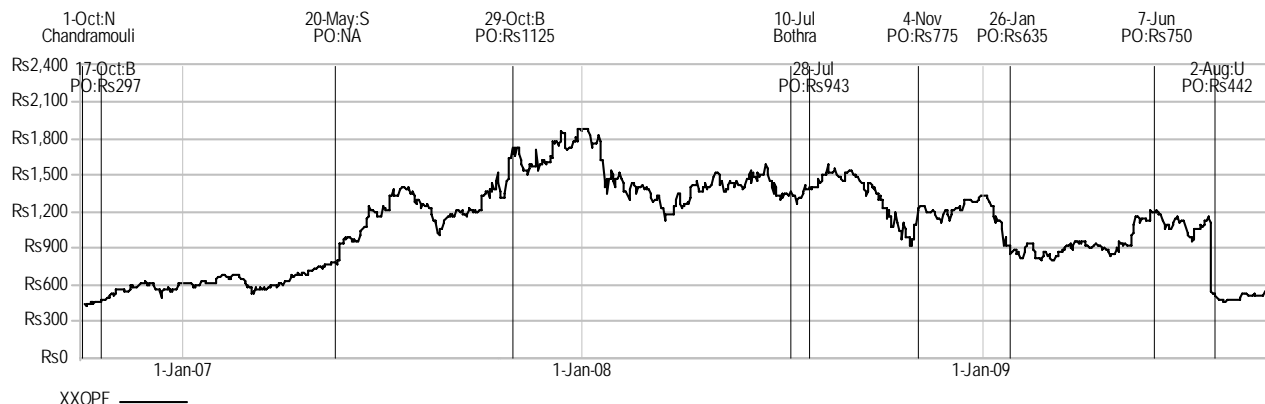
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XXQPF Price Chart



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

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	93	49.73%	Buy	56	64.37%
Neutral	46	24.60%	Neutral	29	69.05%
Sell	48	25.67%	Sell	23	51.11%

Investment Rating Distribution: Global Group (as of 01 Sep 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1528	47.19%	Buy	740	53.86%
Neutral	815	25.17%	Neutral	436	60.39%
Sell	895	27.64%	Sell	378	45.99%

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