Divi's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,283	DIVI IN
	REUTERS CODE
S&P CNX: 4,148	DIVI.BO

Equity Shares (m)	12.8
52-Week Range	3,239/1,118
1,6,12 Rel. Perf. (%)	7/81/47
M.Cap. (Rs b)	40.1
M.Cap. (US$ b)	0.9

27 January 2007

Neutral

Previous Recommendation: Neutral

Rs3,126

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	700	54.6	5.1	57.2	11.8	22.4	26.8	10.9	35.5
03/07E	6,501	1,235	96.3	76.3	32.5	9.1	31.7	32.8	6.4	22.1
03/08E	7,909	1,601	124.9	29.7	25.0	7.1	31.9	33.4	5.3	17.4

3QFY07 performance was better than estimates, mainly boosted by tax writeback. Key highlights:

- Net sales grew by 38% (in line with estimates) while PAT grew 73% to Rs327m (versus estimate of Rs257m). Significant growth in generics and custom chemical synthesis (CCS) business (not quantified) has led topline growth. 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.
- EBITDA margins declined 40bp to 28.4% mainly due to higher generic sales (which attract lower margins), higher staff costs (up 210% incl. ESOP charges of Rs60m) and expenses due to commissioning of new facilities.
- PAT grew by 73% to Rs327m, boosted mainly by significantly lower tax provision. PBT at Rs425m was in line with our estimates of Rs407m. The company has converted one of its existing units into an EoU effective 1 June 2006 and has also commissioned the first phase of its new SEZ unit on 27 October 2006. Sales from these units enjoy tax exemption resulting in effective tax rate of 7.3%. In fact, at the current-tax level, the company recorded a tax writeback of Rs1m (v/s est. tax outgo of Rs81m). Divi's has indicated that the tax rate is likely to increase in 4Q.
- We have revised our FY07E and FY08E EPS estimates upward by 10% and 6% to factor in the lower-than-expected tax rate. We expect Divi's to be a key beneficiary of increased pharmaceutical outsourcing from India. The company's existing relationships with innovator companies should help it procure more MNC contracts. While we remain extremely positive of Divi's future prospects, the rich valuations at 32.5x FY07E and 25x FY08E earnings have tempered our optimism. We maintain our **Neutral** recommendation.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Op Revenue	**646**	**814**	**1,080**	**1,271**	**1,608**	**1,614**	**1,496**	**1,783**	**3,811**	**6,501**
YoY Change (%)	*5.4*	*7.8*	*6.8*	*16.1*	*148.8*	*98.3*	*38.6*	*40.3*	*9.7*	*70.6*
Total Expenditure	443	549	769	883	1,148	1,179	1,071	1,231	2,644	4,628
EBITDA	**203**	**265**	**311**	**388**	**461**	**435**	**425**	**551**	**1,167**	**1,872**
Margins (%)	*31.5*	*32.5*	*28.8*	*30.5*	*28.6*	*26.9*	*28.4*	*30.9*	*30.6*	*28.8*
Depreciation	36	37	37	39	43	42	59	81	148	224
Interest	11	9	14	21	21	6	38	40	56	105
Other Income	37	22	22	26	44	34	25	46	106	148
PBT	**193**	**241**	**282**	**354**	**441**	**421**	**353**	**476**	**1,069**	**1,691**
Tax	64	77	89	103	167	114	-1	92	333	372
Deferred Tax	1	4	4	22	6	-6	27	57	31	85
Rate (%)	*33.8*	*33.7*	*33.0*	*35.3*	*39.4*	*25.7*	*7.3*	*31.3*	*34.1*	*27.0*
Adj PAT	**128**	**159**	**189**	**229**	**267**	**313**	**327**	**327**	**705**	**1,235**
YoY Change (%)	*-11.0*	*18.3*	*24.0*	*-0.3*	*109.6*	*96.2*	*73.2*	*42.9*	*6.7*	*75.2*
Margins (%)	*19.7*	*19.6*	*17.5*	*18.0*	*16.6*	*19.4*	*21.9*	*18.4*	*18.5*	*19.0*

E: MOSt Estimates

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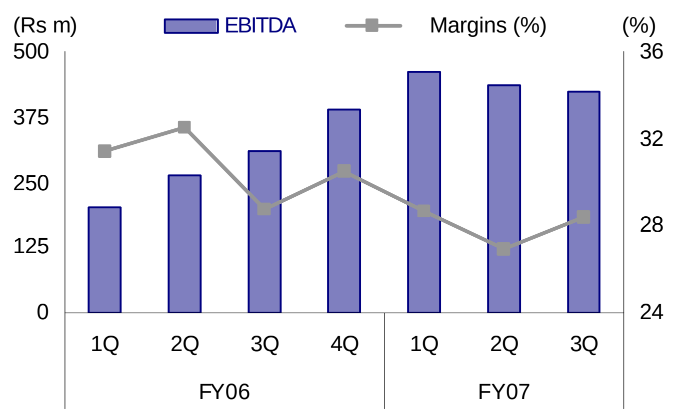
Significant growth in generics and CCS businesses

Net sales during the quarter grew by 38% to Rs1.5b, based on significant growth in the generics and custom chemical synthesis (CCS) business (not quantified). The increase in business is due to significant growth in sales to innovator companies for the CCS business and higher traction in generics sales (Naproxen, Dextromethrophan, Diltiazem, etc). 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 generic sales and increased staff costs impact EBITDA margins

EBITDA margins declined by 40bp to 28.4% mainly due to higher generic sales (which attract lower margins), higher staff costs (up 210% incl. ESOP charges of Rs60m) and expenses linked to commissioning of new facilities.

TREND IN EBITDA



Source: Company/Motilal Oswal Securities

Tax writeback boosts PAT

PAT grew by 73% to Rs327m boosted mainly by significantly lower tax provision. PBT at Rs425m was in line with our estimates of Rs407m. The company has converted one of its existing units into an EoU with effect from 1 June 2006 and has also commissioned the first phase of its new SEZ unit on 27 October 2006. Sales from these units enjoy tax exemption resulting in effective tax rate of 7.3%. In fact, at the current-tax level, the company recorded a tax writeback of Rs1m (v/s est. tax outgo of Rs81m). Divi's has indicated that the tax rate is likely to increase in 4Q.

Generics business: Global M&A leads to significant traction

Divi's generics business accounts for about 60-70% of 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 were growing at a steady 10% YoY growth till FY06. Since pricing for these products has already stabilized (the products being 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 dominant positioning in these products.

However, Divi's is witnessing significant growth in its generics business (more than 100%) in FY07 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 favor of the company. While no further details are available, we believe that this shift in sourcing will continue through to 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 a total of 25 USFDA DMFs. Divi's is targeting a pipeline of 25-30 generic products going off-patent over the next 5-10 years. We believe Divi's would be commercializing most of these products FY08E onward.

CCS business: to expand in the coming years

Divi's CCS business contributes about 30-40% of the total turnover. 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).

3QFY07 saw Divi's CCS business grow by about 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.

Carotenoids - Divi's initially targeting the US$1b market

Divi's has identified eight carotenoids like Beta-carotene, Lycopene, Astaxanthin and Canthaxanthin as 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 the company to entrench itself and face competition.

We believe 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 until the time it is able to establish its credentials in the market.

Divi's is in the process of setting up the required facilities for converting 100% pure carotenoids into granules (beadlet technology) which can be used by its customers directly. This facility is likely to be ready by end-FY07E and supplies are likely to commence in FY08E post receipt of regulatory approvals. We estimate supplies worth US$10m (~ 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). It has already commenced business development activities through these subsidiaries.

Benefits of capacity expansion to accrue from FY08E

Divi's has recently (in October 2006) commissioned the first phase of its new SEZ API unit at Vizag (Andhra Pradesh) at a capex of about Rs800m. 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 October 2006 and is expected to commence contributing to revenues 4QFY07 onward, while the full benefits of the capacity expansion are likely to be visible in FY08E.

Revising estimates

While Divi's 3QFY07 performance was in line with estimates up to the PBT level, lower tax provisioning resulted in PAT of Rs327m (v/s our estimates of Rs257m). We have revised our earnings estimates upward to factor in the lower-than-expected tax rate. We have revised our FY07E EPS upward by 10% to Rs96.3 and FY08E EPS by 6% to Rs125. As a result, our target price has also been revised upward by 6% to Rs2,500.

REVISED FORECAST (RS M)

	FY07E			FY08E		
	REV	OLD	CHG (%)	REV	OLD	CHG (%)
Net Sales	6,501	6,501	0.0	7,909	7,909	0.0
Net Profit	1,235	1,119	10.3	1,601	1,514	5.8
EPS (Rs)	96.3	87.3	10.3	124.9	118.1	5.8

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/neutraceuticals 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 favor 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 until end-FY07E and then revert 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. Its IPR compliance policies coupled with strong relationships with innovator pharmaceutical companies will ensure that the CCS business continues to grow strongly led by new contracts and ramp-up in existing contracts.

Divi's business model is different from that of 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 above 30% for next two years despite the significant capex. We expect pharmaceutical outsourcing to gain traction from FY08E 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 procure more MNC contracts. While we remain extremely positive about Divi's future prospects, the rich valuations at 32.5x FY07E and 25x FY08E earnings have tempered our optimism. We maintain our **Neutral** rating on the stock with our revised target price of Rs2,500.

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 October 2006
- Received reimbursement of 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 34% and 41% expected over FY06-FY09E
- Valuations at 32.5x FY07E and 25x FY08E 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	SHASUN
P/E (x)	FY07E	32.5	23.5	-
	FY08E	25.0	17.0	9.8
P/BV(x)	FY07E	9.1	5.0	2.8
	FY08E	7.1	4.3	2.3
EV/Sales(x)	FY07E	6.4	2.4	0.9
	FY08E	5.3	2.1	0.7
EV/EBITDA(x)	FY07E	22.1	14.7	9.2
	FY08E	17.4	12.1	6.5

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoters	53.9	53.9	54.0
Domestic Institutions	12.2	11.2	7.9
FIIs/FDIs	16.5	16.9	21.0
Others	17.4	18.0	17.1

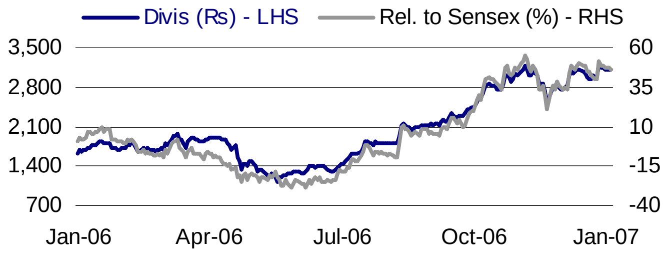
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	96.3	-	-
FY08	124.9	-	-

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
3,126	2,500	-20.0	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	**3,474**	**3,811**	**6,501**	**7,909**	**9,267**
Change (%)	*14.7*	*9.7*	*70.6*	*21.7*	*17.2*
Total Expenditure	2,428	2,644	4,628	5,507	6,419
% of Sales	*69.9*	*69.4*	*71.2*	*69.6*	*69.3*
EBITDA	**1,046**	**1,167**	**1,872**	**2,402**	**2,848**
Margin (%)	*30.1*	*30.6*	*28.8*	*30.4*	*30.7*
Depreciation	151	148	224	289	358
EBIT	**895**	**1,019**	**1,648**	**2,112**	**2,490**
Int. and Finance Charges	43	56	105	163	186
Other Income - Rec.	171	106	148	186	217
PBT before EO Expense	1,024	1,069	1,691	2,135	2,521
Extra Ordinary Expense/(Inc	0	0	0	0	0
PBT after EO Expense	1,024	1,069	1,691	2,135	2,521
Current Tax	330	338	372	427	504
Deferred Tax	27	31	85	107	50
Tax Rate (%)	*34.9*	*34.5*	*27.0*	*25.0*	*22.0*
Reported PAT	**661**	**705**	**1,235**	**1,601**	**1,966**
PAT Adj for EO Items	**666**	**700**	**1,235**	**1,601**	**1,966**
Change (%)	*-9.0*	*5.1*	*76.3*	*29.7*	*22.8*
Margin (%)	*19.2*	*18.4*	*19.0*	*20.2*	*21.2*

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	**52.0**	**54.6**	**96.3**	**124.9**	**153.4**
Cash EPS	63.7	66.2	113.8	147.5	181.4
BV/Share	221.3	265.9	341.7	441.7	564.4
DPS	8.0	10.0	17.9	21.9	26.9
Payout (%)	17.7	20.7	21.2	20.0	20.0
Valuation (x)					
P/E		57.2	32.5	25.0	20.4
Cash P/E		47.2	27.5	21.2	17.2
P/BV		11.8	9.1	7.1	5.5
EV/Sales		10.9	6.4	5.3	4.5
EV/EBITDA		35.5	22.1	17.4	14.5
Dividend Yield (%)		0.3	0.6	0.7	0.9
Return Ratios (%)					
RoE	26.0	22.4	31.7	31.9	30.5
RoCE	33.1	26.8	32.8	33.4	31.3
Working Capital Ratios					
Debtor (Days)	107	103	120	120	120
Creditor (Days)	70	110	66	66	66
Inventory (Days)	146	176	110	110	110
Working Capital Turnover (D	197	205	169	169	169
Leverage Ratio (x)					
Current Ratio	3.4	2.7	3.2	3.3	3.5
Debt/Equity	0.2	0.4	0.4	0.4	0.3

BALANCE SHEET					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Equity Share Capital	128	128	128	128	128
Total Reserves	2,708	3,280	4,252	5,534	7,107
Net Worth	**2,837**	**3,408**	**4,381**	**5,662**	**7,235**
Deferred liabilities	250	282	366	473	523
Total Loans	661	1,502	1,650	2,055	2,360
Capital Employed	**3,748**	**5,192**	**6,397**	**8,190**	**10,118**
Gross Block	2,538	3,019	4,019	5,019	6,019
Less: Accum. Deprn.	723	871	1,095	1,384	1,743
Net Fixed Assets	**1,815**	**2,148**	**2,924**	**3,634**	**4,276**
Capital WIP	11	803	80	100	120
Investments	0	4	100	400	400
Curr. Assets	**2,717**	**3,546**	**4,763**	**5,842**	**7,434**
Inventory	1,390	1,839	1,950	2,373	2,780
Account Receivables	1,022	1,074	2,145	2,610	3,058
Cash and Bank Balance	45	101	277	385	1,039
Loans & Advances	260	532	390	475	556
Curr. Liability & Prov.	**795**	**1,309**	**1,470**	**1,787**	**2,112**
Account Payables	668	1,152	1,170	1,424	1,668
Provisions	127	158	299	363	444
Net Current Assets	**1,922**	**2,237**	**3,293**	**4,055**	**5,322**
Appl. of Funds	**3,748**	**5,192**	**6,397**	**8,190**	**10,118**

E: MOSt Estimates

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Op.Profit/(Loss) bef. Tax	1,046	1,167	1,872	2,402	2,848
Interest/Dividends Recd.	171	106	148	186	217
Direct Taxes Paid	-330	-338	-372	-427	-504
(Inc)/Dec in WC	-493	-259	-880	-654	-612
CF from Operations	**394**	**677**	**768**	**1,507**	**1,948**
EO Expense / (Income)	0	0	0	0	0
CF from Operating incl	**394**	**677**	**768**	**1,507**	**1,948**
(inc)/dec in FA	-259	-1,272	-278	-1,020	-1,020
(Pur)/Sale of Investments	1	-4	-96	-300	0
CF from Investments	**-258**	**-1,276**	**-374**	**-1,320**	**-1,020**
Issue of Shares	1	13	0	0	0
(Inc)/Dec in Debt	2	841	148	405	305
Interest Paid	-43	-56	-105	-163	-186
Dividend Paid	-117	-146	-262	-320	-393
Others	-5	4	0	0	0
CF from Fin. Activity	**-163**	**656**	**-219**	**-79**	**-274**
Inc/Dec of Cash	**-27**	**56**	**175**	**108**	**655**
Add: Beginning Balance	72	45	101	277	385
Closing Balance	**45**	**101**	**277**	**385**	**1,039**

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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