

14 August 2007

Not Rated

Price **Rs.1,265** Target Price **N.A.**

Sensex **-15,017**

Price Performance

(%)	1M	3M	6M	12M
Absolute	(7)	64	92	251
Rel. to Sensex	(4)	51	80	161

Source: Bloomberg

Stock Details

Sector	Pharmaceuticals
Reuters	DIVI.BO
Bloomberg	DIVI@IN
Equity Capital (Rs mn)	129
Face Value	Rs2
52 Week H/L	Rs1,436/346
Market Cap(Rs bn)	81.7
Daily Avg Volume (No of shares)	1256259
Daily Avg Turnover (US\$m)	36.2

Shareholding Pattern (%)

Promoters	53.6
FII/NRI	15.3
Institutions	14.0
Private Corp.	4.6
Public	12.5

Source (30th June'07)

Source: Capitaline

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Divi's Laboratories Ltd.

Visit Note

Strong fundamentals reflected in valuation

Divi's Laboratories Ltd. (Divi's) is one of the foremost players in the contract research and manufacturing services (CRAMS) space. To understand its future growth strategy, we met with the management of the company. Divi's has a unique and de-risked business model that provides custom manufacturing and research services to global innovative and generic players with strict adherence to the Intellectual Property Rights (IPR). Divi's is currently serving 20 of the top 25 global innovators companies in various custom manufacturing contracts. Company's focus on custom synthesis business (CSB) has resulted in strong revenue growth in FY07, which has grown by 90% to Rs.7.24bn from Rs.3.81bn in FY06. Management expects revenues to grow at a CAGR of 25% p.a. for next 2 years and EBIDTA margins should sustain at current level (34-35%). We do not have any rating on the stock but believe that current valuations adequately factor in the high earnings expectations. Recently company has split its stock from face value of Rs10 to Face value of Rs.2. At CMP of Rs.1,265 (post stock split), the stock is trading at 34x consensus CY08E EPS of Rs.37.06 and 27x consensus CY 09E EPS of Rs.45.96.

Custom synthesis business- high growth trajectory

Custom synthesis business currently contributes 50% of its total sales, up from 30% in FY06. Revenues from custom synthesis business grew from Rs.1.14bn in FY06 to Rs.3.62bn in FY07 (massive growth of 217%) on the back of its strong relation with global innovators companies. Since Divi's work with its partner right from the development stage, it enjoys higher margins on CSB and hopes to cash on the deal when any NCEs for which it developing process receives final approval. Divi's has also identified nutraceutical business as its future growth driver, for which, it has set up a bead-let plant with an investment of Rs.350mn.

Strong generic pipeline

Divi's has got a very strong generic APIs pipeline and has built market leadership in few of the key APIs. Divi's is the largest manufacturer of Naproxen (NSAID) in the world and this product is single largest contributor for Divi's, contribute 21% of the sales. Other key products in the generic space are Nabumetone, Dextromethopran, Iopamidol and Phenylephrine. This segment contribute 50% of the total sales and during the year it has filed 2 DMFs with US FDA and 9 dossiers with European countries taking its cumulative filing with US FDA to 28 and 8 with European Directorate.

Valuations

The stock is currently trading at 34x its consensus CY08E EPS of Rs.37.06 and 27x consensus CY09E EPS of Rs.45.96 (source: Bloomberg). The management has given the guidance of 25% growth in revenues and EBIDTA margins to sustain at current level (34-35%). **We do not have rating on the stock but believe that current valuations adequately factor in the high earnings expectations. Our views are NEUTRAL on the stock.**

Key Financials

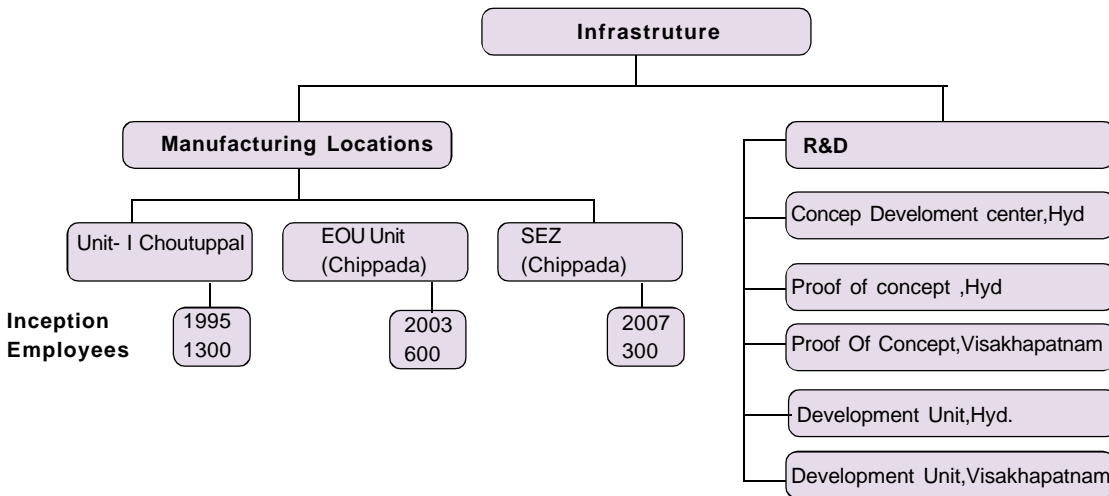
Year	Net Sales	EBIDTA		PAT	EPS*	ROE	P/E	EV/	P/BV	Div. Yld
End	(Rs mn)	Core	(%)	(Rs mn)	(Rs)	(%)	(x)	EBIDTA (X)	(x)	(%)
FY04	3028	1041	34.4	728	11.4	31.8	111.0	78.2	35.2	0.6
FY05	3474	1045	30.1	660	10.3	25.8	122.5	78.0	28.5	0.6
FY06	3811	1167	30.6	705	11.0	22.6	114.8	70.6	23.7	0.8
FY07	7244	2460	34.0	1917	29.7	43.4	42.4	33.7	15.0	0.8

* Post stock split

Company & business Profile

Started as Divi's Research Center (DRC) in 1990 by Dr. Murli K. Divi (having over 30 years of expertise in the global pharmaceutical industries), it has established itself as one of the leading manufacturers of APIs and intermediates in the business of customer synthesis, nutraceuticals, building blocks for peptides and generics. Today Divi's has 4 R&D centers with focus on custom synthesis, contract research for MNC companies and developing process for future generics. A team of 200 scientists is currently working on different projects. It has got three international standard manufacturing facilities, which are US FDA compliant. Its unit at Chippada is the first Pharma SEZ unit in the country, which was commissioned during FY07. Company has also converted its second unit at Chippada as Export Oriented Unit (EOU) and started operation as EOU from 1st June 2006.

Infrastructure



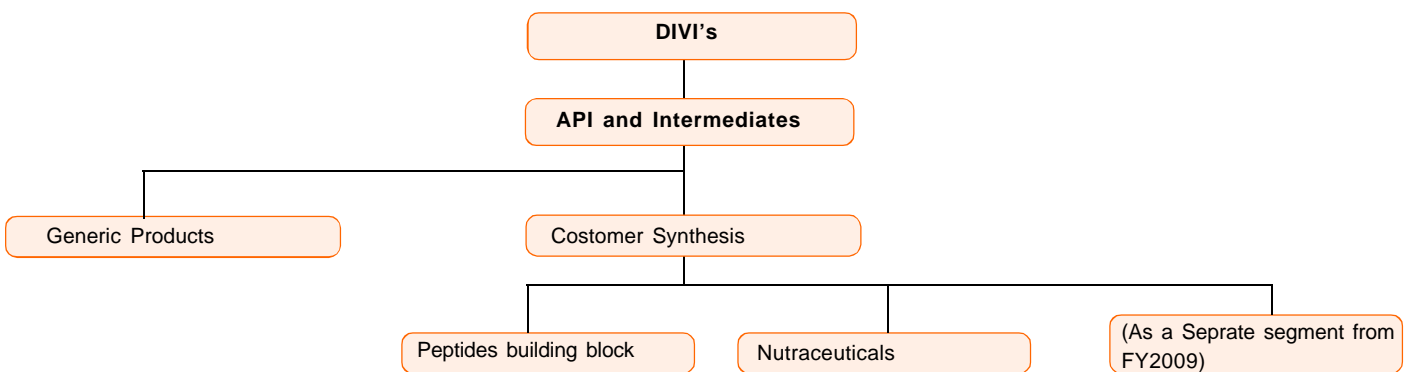
Source: Emkay research,Company

Business Model

Divi's has built up a unique de-risked business model, which stands out from other CRAMS players. Over the years it has built up strong relationship with global innovator companies because of its strategies to adhere with the development of non-patent infringing process. As a result, today 20 out of top 25 innovator companies are its customers. Divi's has major focus in the regulated markets of US and the Europe.

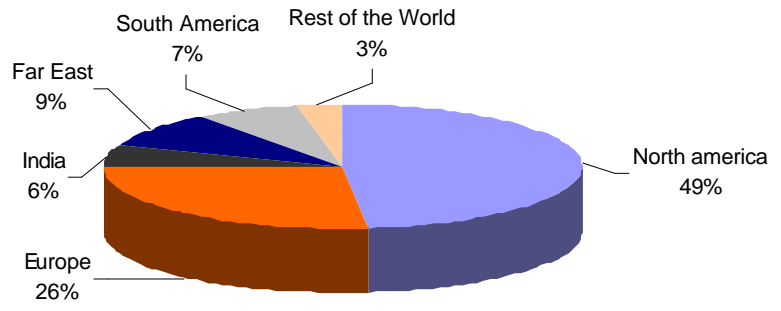
Custom synthesis business contributes 50% of its total sales and balance comes from generic APIs. In generic space, Naproxen is the single largest contributor (21%) and top 5 customers contribute 50% of the sales. Export constitute 93% of the total revenues and mainly dominated by the regulated markets of US and Europe, contribute 75% of the total sales.

Business Model



Source: Emkay research,Company

Geographical Revenue- Break-up



Source: Emkay research

Industry Profile

The success of business process outsourcing (BPO) related services in India has prompted a few companies to start off shoring high-end knowledge based activities like clinical research, drug discovery and patent filing, etc. Contract research is the major activity of the Knowledge Process Outsourcing (KPO) industry in the pharmaceutical sector.

Global custom manufacturing market is expected to grow steadily over the next few years. As per frost & Sullivan, the market can grow to US\$25.7bn by 2011. Innovators are looking for more cost effective manufacturing, as they face increasing margins pressure. This changing paradigms are driving global pharma companies to aggressively seek partnerships with low cost Asian players to enhance there competitiveness across the entire product life cycle from the clinical development stage to commercialisation and even after the expiry of patents. Post India's signing of trips in 2005, the comfort level of innovators has increased with Indian companies.

Custom manufacturing market in India is expected to reach \$1.5bn by 2010 (current size: \$800mn in FY07). Indian CRAMS players are well placed to capitalize these opportunities because of

- Cost and Skill advantage
- Higher no. Of USFDA approved plants
- Large English speaking scientists
- Presence across the value chain

We believe that the companies who have high manufacturing capabilities and strong relationship with global innovators companies are going to gain the most of this rising opportunities.

Key growth drivers

Custom Synthesis business-on a high growth trajectory

Divi's has emerged as a preferred partner to global innovators companies because of its ability to offer a complete solution to its customer right from process development to custom synthesis of APIs and intermediates. Today Divi's has one of the largest custom synthesis pipelines and its client strength varies from 150 to 200.

Custom synthesis business has shown considerable growth in FY07 (grew by 217% to Rs.3.62bn) and enjoys high EBIDTA margins. Since Divi's strictly adhere to IPR and develop non-patent infringing process, today it serves 20 out of top 25 global innovators companies. Going forward, we expect custom synthesis business continue to do well as company prefers to associate with innovators early in their new drug discovery and development cycle to cash on the deal when molecule become commercially successful.

Peptides-building blocks

Across the globe, peptides and nucleotides are getting significant importance because of its novel therapeutic value. Divi's has been able to identify this opportunity quite early and today it is one of the largest producers of peptide and nucleotide building blocks that are used as bulk drugs for effective drug formulations. Oncology is the largest peptides segment accounting for around 65% of global peptide market (Global peptide market is estimated at US\$7bn).

Though currently this segment is small, contributing only 6% of its custom synthesis business, but going forward, we expect it to be double by 2010 from its current level. Currently it is supplying building blocks to eight peptide manufacturers. Jupiter bioscience is another competitors for Divi's in peptide business in India.

Generic APIs-consistent growth ahead

The global API market is estimated about 5 to 7% of the total pharma market (total pharmaceutical market is US\$643bn in 2007 and growing @ 7% pa), i.e. between US\$35 to US\$ 45bn. Right from the beginning, Divi's is following a very focus strategy to be one among the top three in the world for each generic API which they produce. Today this segment contributes 50% of the total revenues and because of economics of scale, they are able to offer very competitive rates and enjoy fairly good margins. Naproxen is single largest product for Divi's; contribute 21% of the total sales. Divi's is now filing DMFs of those products which are likely to go off patent in next 3-4 years, therefore to get first-to-file (FTF) status and able to supply the large quantity orders once the product go off patent. Currently Divi's has FTF status for levitracetam, which is going to go off patent by August 2009. IN FY07, Divi's has filed 2 DMFs with US FDA and 9 dossiers with European countries taking its cumulative filing with US FDA to 28 and 8 with European Directorate.

Nutraceuticals-the next growth driver

Divi's has set-up a bead-let plant with an investment of Rs.350mn in their SEZ, which is going to be operational next month. Divi's is betting big on this project and expect it to be future growth driver. Divi's is one among very few manufacturers who got expertise in manufacturing nutraceuticals like carotenoids using chiral synthesis with fully validated and backward integrated manufacturing process from molecule to finished form. We expect this business to contribute Rs.500mn by FY09E.

Infrastructure is in place

Divi's has developed an SEZ in Chippada, Visakhapatnam. The total capex for this project would be Rs. 1020mn and first phase of this project is already operational from Oct' 06. Divi's has also converted its existing manufacturing unit at Chippada into Export Oriented Unit (EOU) from June' 06. Though these initiatives has led to higher outgo of depreciation cost (up by 51%) and interest cost (up by 89%), however, effective tax rate has come down from 34% in FY06 to 15.4% in FY07 due to higher contribution from the new SEZ. Going forward, we expect it to come down to 12%. Management has also indicated that for next 2 years there will not be any major capex.

Financials

Divi's has posted robust growth in revenues and earnings in FY07. On standalone basis, revenues grew by 90% to Rs.7.24bn in FY07 (Rs.3.81bn in FY06) driven by buoyant growth in CSB, grew by 217% to Rs.3.62bn and now contribute 50% of its total sales. EBIDTA margins have improved significantly from 30.6% in FY06 to 34% in FY07, driven by higher operating margins in CSB (though the employee cost has increased by 183% on account of ESOP charges to the tune of around Rs.241mn in FY07). Though depreciation cost and interest cost have increased by 51% and 89% respectively because of new SEZ facility, but higher contribution from this new SEZ facility has resulted lower effective tax rate (15.4% in FY07 v/s 34% in FY06). As a result, PAT recorded growth of 172% to Rs.1917mn (Rs.704mn in FY06). NPM has improved from 18.5% in FY06 to 26.5% in FY07.

Robust Q1 result

For Q1FY08, Divi's recorded revenues of Rs.2280.7mn, up by 42% (y-o-y basis). EBIDTA margins for the quarter was increased by 830 bps to 36.9%. Net profit increased by 151% from Rs.267mn to Rs. 672.8mn translating into diluted EPS of Rs.10.4.

Expect growth at 24% CAGR in topline

Our quick estimates, also guided by the management suggest that the Divi's is likely to achieve a CAGR of 24% in topline to Rs.11.14bn by FY09E. PAT should increase at a CAGR (FY07-09E) of 27% to Rs.3.07bn.

Quick Estimates

	FY06	FY07	FY08E	FY09E	CAGR%
Net Sales	3811	7244	9055	11138	24%
EBIDTA %	30	34	35	36	
EBIDTA	1167	2460	3169	4010	28%
Int.& Dep.	204	329	500	620	37%
Other Income	106	136	100	100	-2%
PBT	1069	2267	2769	3490	24%
Tax Rate%	34	15	12	12	
PAT	705	1917	2437	3071	27%
PAT margins	18.5	26.5	26.9	27.6	
Equity*	64.1	64.6	64.6	64.6	
EPS	11.0	29.7	37.8	47.6	27%

* Estimates are rough estimate by Emkay and as per indication given by management

* Post stock split

Valuations and outlook

The stock is currently trading at 34x its consensus CY08E EPS of Rs.37.06 and 27x consensus CY09E EPS of Rs.45.96 (source: Bloomberg). The management has given the guidance of 25% growth in revenues and EBIDTA margins to sustain at current level (34-35%). **We do not have rating on the stock but believe that current valuations adequately factor in the high earnings expectations. Our views are NEUTRAL on the stock.**

Quarterly results

Income Statement		Standalone					
Y/E,Mar (Rs. m)	Q1FY08E	Q1FY07	%YoY	%Q-o-Q	FY07	FY06	%Y-o-Y
Net Sales	2281	1608	41.8	-9.7	7244	3811	90.1
Expenses	1438	1148	25.3	3.7	4784	2644	80.9
Raw Materials	1009	820	23.1	12.5	3231	1698	90.3
% of sales	44.2	51.0			44.6	44.6	
Employee cost	114.8	96.4	19.1	-37.9	515.8	182.0	183.4
% of sales	5.0	6.0			7.1	4.8	
Other expenses	314.3	232.0	35.6	2.9	1037.5	764.1	35.8
% of sales	13.8	14.4			14.3	20.0	
EBIDTA	843	461	83	(26.0)	2460	1167	111
EBIDTA %	36.9	28.6	830 bps	(820 bps)	34.0	30.6	340bps
Other income	34.4	43.6	(21.1)	1.2	136.1	106.3	28.0
Interest	33.7	20.6	63.6	(17.0)	105.7	55.8	89.4
Depreciation	86.1	42.6	102.1	7.1	223.3	148.2	50.7
PBT	757.2	441	71.7	(28.0)	2267	1069	112.0
Total Tax	84.4	174	(51.4)	100.5	349.6	364.4	(4.1)
Effective tax rate (%)	11.1	39.4			15.4	34.1	
PAT	672.8	268	151.5	(33.4)	1917.4	704.7	172.1
E/O items	0	0		7	0	0	
Adjuted PAT	672.8	268	151.5	(33.4)	1917.4	704.7	172.1
Net Margin (%)	29.5	16.6			26.5	18.5	
Equity*	64.6	64.1			64.55	64.1	
EPS (diluted)	10.4	4.2	149.8	(33.3)	29.7	11.0	170.2

* Post stock split

Financials

Income Statement		Standalone			
Y/E,Mar (Rs. m)	FY04	FY05	FY06	FY07	
Net Sales	3028	3474	3811	7244	
Expenses	1987.2	2428	2644.3	4784.3	
Raw Materials	1267.1	1584	1698.2	3231	
% of sales	41.8	45.6	44.6	44.6	
Employee cost	125.5	151	182	515.8	
% of sales	4.1	4.3	4.8	7.1	
Other expenses	594.6	694	764.1	1037.5	
% of sales	19.6	20.0	20.0	14.3	
EBIDTA	1041.1	1045.0	1166.8	2459.9	
EBIDTA %	34.4	30.1	30.6	34.0	
Other income	144.5	171	106.3	136.1	
Interest	33.6	43	55.8	105.7	
Depreciation	132.4	151	148.2	223.3	
PBT	1019.6	1023	1069.1	2267	
Total Tax	291.2	363	364.4	349.6	
Effective tax rate (%)	28.6	35.5	34.1	15.4	
PAT	728.4	660	704.7	1917.4	
E/O items	0	0	0	0	
Adjuted PAT	728.4	660.0	704.7	1917.4	
Net Margin (%)	24.1	19.0	18.5	26.5	
Equity*	64.1	64.1	64.1	64.55	
EPS (diluted)	11.4	10.3	11.0	29.7	

* Post stock split

Balance Sheet

Y/E, Mar (Rs. mn)	FY04	FY05	FY06	FY07
Equity share capital	128	128	128	129
Reserves and surplus	2164	2708	3280	5291
Networth	2292	2837	3408	5420
Deferred tax liability	223	250	282	295
Secured Loans	110	33	607	918
Unsecured Loans	549	628	895	622
Loan Funds	659	661	1502	1540
Capital Employed	3174	3748	5192	7255
Gross Block	2236	2538	3019	4907
Less: Depreciation	573	723	871	1095
Net block	1663	1815	2148	3812
Capital work in progress	55	11	803	383
Investment	1	0	4	6
Current Assets	2115	2717	3546	4314
Inventories	1076	1391	1839	2101
Sundry debtors	868	1022	1074	1645
Cash & bank balance	72	45	102	172
Loans & advances	100	260	532	397
Other assets	0	0	0	0
Current liabilities	660	795	1309	1259
Current liabilities	532	668	1152	1239
Provisions	128	127	158	19
Net current assets	1455	1922	2237	3055
Total Assets	3174	3748	5192	7255

Key Ratios (%)

Mar end	FY04	FY05	FY06	FY07
Profitability (%)				
EBIDTA margin	34.4	30.1	30.6	34.0
PAT margin	24.1	19.0	18.5	26.5
ROCE	27.5	24.9	22.1	35.4
ROE	31.8	25.8	22.6	43.4
Per share data (Rs.)				
EPS (Consolidated)	11.4	10.3	11.0	29.7
CEPS	13.4	12.6	13.3	33.2
BVPS	35.8	44.2	53.1	84.0
DPS (Rs)	8.0	8.0	10.0	10.0
Valuations				
P/E	110.9	122.5	114.8	42.4
Cash PE	93.8	99.7	94.8	38.0
P/BV	35.2	28.5	23.7	15.0
EV / Net Sales	26.9	23.5	21.6	11.4
EV / EBITDA	78.2	78.0	70.6	33.7
Dividend Yield (%)	0.6	0.6	0.8	0.8

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