Divi's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,998	DIVI IN
	REUTERS CODE
S&P CNX: 2,917	DIVI.BO

Equity Shares (m)	12.8
52-Week Range	2,009/1,037
1,6,12 Rel. Perf. (%)	-9/-22/-28
M.Cap. (Rs b)	15.7
M.Cap. (US$ b)	0.3

19 June 2006

Buy

Previous Recommendation: Buy

Rs1,227

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	705	55.0	5.8	22.3	4.6	22.6	26.3	4.5	14.8
03/07E	4,337	792	61.8	12.3	19.9	3.9	21.4	23.6	4.0	13.1
03/08E	4,928	1,046	81.6	32.2	15.0	3.2	23.6	25.6	3.4	10.6

Divi's Labs 4QFY06 performance was marginally lower than expectations as margins expanded only by 100bp to 30.5% (v/s estimate of 32.7%). Key highlights:

- In 4QFY06, sales grew by 16.1% to Rs1.27b (v/s estimate of Rs1.24b) while PAT were flat at Rs229m (v/s estimate of Rs238m).
- EBITDA margins for 4QFY06 expanded just by 100bp to 30.5% (v/s estimate of 32.7%) impacted by 53% YoY increase in staff cost. However, lower than expected interest cost at Rs21m (v/s estimate of Rs38m) resulted in PBT growth of 8% to Rs354m (v/s estimate of Rs350m). Higher tax provisioning at 35.3% of PBT (v/s 30% in 4QFY05) resulted in 0.3% decline in PAT to Rs229m.
- For FY06, sales grew by 9.7% to Rs3.8b, with margin expanding by 50bp to 30.6%, translating into 6.7% growth in PAT to Rs705m.
- Divi's has announced cancellation of one of its contracts from a US based company, for which it was expected to spend about Rs300m (already incurred capex of Rs250m). Our current estimates already factor-in the impact of the cancellation of the contract.

Divi's is valued at 19.9x FY07E and 15x FY08E earnings. 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. Our estimates, however, do not include upsides from any future contracts that the company may announce or from the Rs800m SEZ proposed by the company. Maintain **Buy**.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Net Op Revenue	**614**	**755**	**1,011**	**1,095**	**646**	**814**	**1,080**	**1,271**	**3,474**	**3,811**
YoY Change (%)	*-0.3*	*24.4*	*22.8*	*11.4*	*5.4*	*7.8*	*6.8*	*16.1*	*14.7*	*9.7*
Total Expenditure	393	517	746	772	443	549	769	883	2,428	2,644
EBITDA	**220**	**238**	**264**	**323**	**203**	**265**	**311**	**388**	**1,045**	**1,167**
Margins (%)	*35.9*	*31.5*	*26.2*	*29.5*	*31.5*	*32.5*	*28.8*	*30.5*	*30.1*	*30.6*
Depreciation	36	38	39	37	36	37	37	39	151	148
Interest	7	8	14	14	11	9	14	21	43	56
Other Income	48	31	37	56	37	22	22	26	171	106
PBT	**225**	**222**	**248**	**328**	**193**	**241**	**282**	**354**	**1,023**	**1,069**
Tax	72	76	87	101	64	77	89	103	335	333
Deferred Tax	10	12	9	-3	1	4	4	22	27	31
Rate (%)	*36.2*	*39.3*	*38.6*	*30.0*	*33.8*	*33.7*	*33.0*	*35.3*	*35.5*	*34.1*
Adj PAT	**143**	**135**	**152**	**230**	**128**	**159**	**189**	**229**	**660**	**705**
YoY Change (%)	*-5.4*	*-13.1*	*-24.8*	*4.8*	*-11.0*	*18.3*	*24.0*	*-0.3*	*-9.4*	*6.7*
Margins (%)	*23.4*	*17.9*	*15.1*	*21.0*	*19.7*	*19.6*	*17.5*	*18.0*	*19.0*	*18.5*

E: MOSt Estimates

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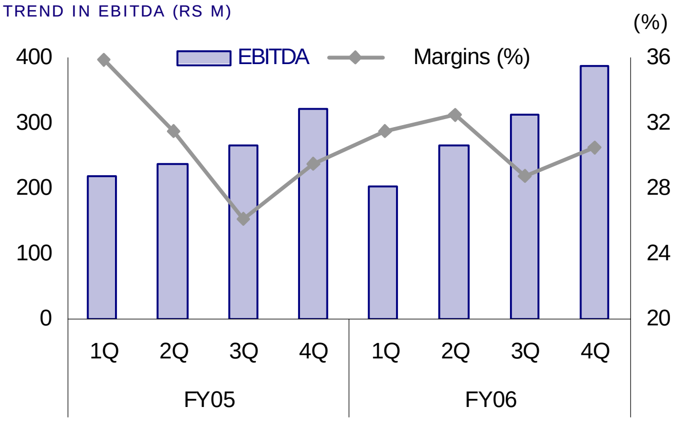
4QFY06 results impacted by higher staff cost

In 4QFY06, sales grew by 16.1% to Rs1.27b, while PAT were flat at Rs229m. EBITDA margins for 4QFY06 expanded just by 100bp to 30.5% impacted by 53% YoY increase in staff cost. However, lower than expected interest cost at Rs21m resulted in PBT growth of 8% to Rs354m. Higher tax provisioning at 35.3% of PBT (v/s 30% in 4QFY05) resulted in 0.3% decline in PAT to Rs229m.

TREND IN EBITDA (RS M)



Source: Company/ Motilal Oswal Securities

For FY06, sales grew by 9.7% to Rs3.8b, with margin expanding by 50bp to 30.6%, translating into 6.7% growth in PAT to Rs705m.

Cancellation of contract with a US-based MNC

In Mar-06, Divi's had announced cancellation of one of its contracts from a US based company. The client had instructed Divi's not to go ahead with the construction of the facilities for servicing this contract. The company has not disclosed the reasons for the cancellation of the contract but has indicated that it was not due to any problems in implementation. Divi's was expected to spend about Rs300m on this facility for which it has already taken forex loans of about $6m. It has already spent Rs250m on the project. This was supposed to be a dedicated facility and hence it cannot be utilized for manufacturing any other product. We had estimated revenues of about Rs200m from this contract for FY07E and Rs300m for FY08E. Our current estimates already factor-in the impact of the cancellation of the contract. While we believe that this is a negative development for Divi's, we also believe that this is a one-off development. Cancellation of contracts at the implementation stage is very rare while there have been instances of cancellation due to lower demand for the customer's products.

Generics business: to grow at a steady pace

Divi's generics business accounts for about 70% of revenues and is hence, the company's most important segment. Its older generic products – Naproxen, Diltiazem and Dextromethorphan (together accounting for about 43% of FY05 sales) – enjoy strong positioning. 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.

While its older products would continue to witness steady growth, Divi's would also see incremental contribution from new generic products. The company has total of 26 USFDA DMFs. 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 most of these products from FY08 onwards. For Levetiracetam, we expect supplies to commence from 1QFY07.

As a policy, Divi's does not support patent challenges due to the clash of business interests with the innovators. However, it has been amongst the first to file DMFs for Levetiracetam (UCB's *Keppra* brand with sales of US$320m) and Proguanil (GSK's *Malarone*). Two generic companies have filed patent challenges for Levetiracetam, including Dr Reddy's. It seems that the other patent challenge may be supported by Divi's DMF for Levetiracetam. This contradicts Divi's stated policy of not entering into patent challenges against innovator companies. However, the company has indicated that it does not intend to back any patent challenges for this product.

CCS business: to expand in the coming years

Divi's CCS business contributed about 22% of its turnover in FY06E. The company is currently working with 20 of the top-25 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, consisting of about 55 products, of which 25 are undergoing phase-III clinical trials. We believe that Divi's has the strongest CCS pipeline amongst Indian players.

Divi's has recently experienced a slowdown in its CCS business 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$300m Astaxanthin 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. The company is targeting the US$300m Astaxanthin market (which is growing at about 15% annually) to begin with.

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 Roche 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 is ready with 100% pure Astaxanthin, which its partner will have to convert to formulation before using it as feed. Divi's has been able to tie up with only one feed manufacturer till date. Its partner is in the process of setting up a plant for manufacturing Astaxanthin formulation. Divi's has indicated that commercial supplies will begin in the next 6-8 months. The company's manufacturing facility at Vizag includes a carotenoids unit. We expect only incremental upsides from carotenoids for Divi's, with revenues estimated at Rs118m for FY07 and Rs179m for FY08.

Benefits of capacity expansion to accrue from FY08

Divi's in the process of setting up a new API unit at Vizag (AP) with SEZ status at a capex of Rs3b. It expects to spend about Rs800m in the first phase of expansion. It plans to raise 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. Divi's has indicated commercialization of the unit by 3QFY07. Hence, the full benefits of the capacity expansion are likely only in FY08. As there is no visibility on the products to be manufactured at this unit, we have not included any upsides from the commissioning of this unit in our estimates.

Our estimates do not include upsides from future contracts, which the company may announce, as there is no visibility on these contracts at this juncture. Also, we have not factored in the revenue upside from the Rs800m SEZ likely to be commercialized by 3QFY07, as there is little visibility on the products to be manufactured at this facility.

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 business.

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 RoE of about 22% despite the significant capex. Our earnings estimates represent the base-case scenario, as we have not included upsides from potential contracts or the new SEZ being set up by the company. We expect pharmaceutical outsourcing to gain traction from FY07, with the top-5 players likely to gain a disproportionate share of the CRAMS business initially. Divi's existing relationships with MNCs would help the company gain more contracts in the future. Divi's is currently valued at 19.9x FY07E and 15x FY08E earnings. Maintain **Buy**.

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

- Cancellation of contract with US-based MNC for which it was incurring capex of Rs300m in setting up a dedicated facility

Valuation and view

- Revenue and Earnings CAGR of 14% and 22% expected over FY06-FY08E
- Valuations at 19.9x FY07E and 15x FY08E do not fully reflect the fact that Divi's will be one of the key beneficiaries of increased outsourcing from India.
- Re-iterate **Buy** with price target of Rs1,764.

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	19.9	20.8	631.6
	FY08E	15.0	16.1	7.4
P/BV(x)	FY07E	3.9	4.1	1.7
	FY08E	3.2	3.7	1.4
EV/Sales(x)	FY07E	4.0	2.2	1.1
	FY08E	3.4	2.0	0.8
EV/EBITDA(x)	FY07E	13.1	14.1	5.6
	FY08E	10.6	11.7	3.9

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	54.0	54.0	54.0
Domestic Institutions	8.8	7.9	6.9
FIIs/FDIs	19.7	21.0	20.3
Others	17.6	17.1	18.9

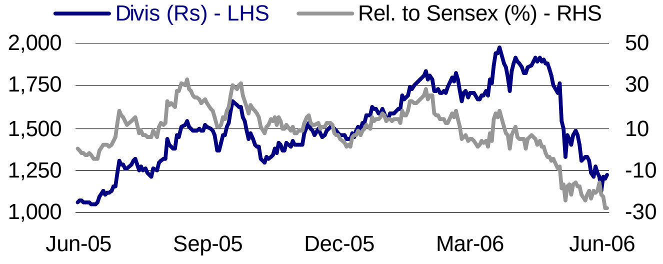
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	61.8	71.2	-13.2
FY08	81.6	83.3	-2.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,227	1,764	43.8	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Net Sales	**3,028**	**3,474**	**3,811**	**4,337**	**4,928**
Change (%)	*22.8*	*14.7*	*9.7*	*13.8*	*13.6*
Total Expenditure	1,987	2,428	2,644	3,013	3,339
% of Sales	*65.6*	*69.9*	*69.4*	*69.5*	*67.8*
EBITDA	**1,041**	**1,046**	**1,167**	**1,324**	**1,589**
Margin (%)	*34.4*	*30.1*	*30.6*	*30.5*	*32.2*
Depreciation	132	151	148	236	275
EBIT	**909**	**895**	**1,019**	**1,088**	**1,314**
Int. and Finance Charges	34	43	56	140	122
Other Income - Rec.	145	171	106	183	207
PBT before EO Expense	1,020	1,024	1,069	1,131	1,399
Extra Ordinary Expense/(Income)		0	0	0	0
PBT after EO Expense	1,020	1,024	1,069	1,131	1,399
Current Tax	243	330	333	249	280
Deferred Tax	45	27	31	90	73
Tax Rate (%)	*28.2*	*34.9*	*34.1*	*30.0*	*25.2*
Reported PAT	**728**	**661**	**705**	**792**	**1,046**
PAT Adj for EO Items	**732**	**666**	**705**	**792**	**1,046**
Change (%)	*33.2*	*-9.0*	*5.8*	*12.3*	*32.2*
Margin (%)	*24.2*	*19.2*	*18.5*	*18.3*	*21.2*

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	**28.5**	**52.0**	**55.0**	**61.8**	**81.6**
Cash EPS	33.7	63.7	66.5	80.2	103.1
BV/Share	89.4	221.3	264.9	313.5	378.8
DPS	8.0	8.0	10.0	11.5	14.3
Payout (%)	15.9	17.7	20.8	21.2	20.0
Valuation (x)					
P/E		23.6	22.3	19.9	15.0
Cash P/E		19.2	18.4	15.3	11.9
P/BV		5.5	4.6	3.9	3.2
EV/Sales		4.7	4.5	4.0	3.4
EV/EBITDA		15.6	14.8	13.1	10.6
Dividend Yield (%)		0.7	0.8	0.9	1.2
Return Ratios (%)					
RoE	36.9	26.0	22.6	21.4	23.6
RoCE	41.6	33.1	26.3	23.6	25.6
Working Capital Ratios					
Debtor (Days)	103	106	113	113	113
Creditor (Days)	154	156	147	151	156
Inventory (Days)	130	146	146	146	146
Working Capital Turnover (I	167	197	211	212	211
Leverage Ratio (x)					
Current Ratio	3.2	3.4	3.6	3.7	3.6
Debt/Equity	0.3	0.2	0.5	0.4	0.3

BALANCE SHEET					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Equity Share Capital	128	128	128	128	128
Total Reserves	2,164	2,708	3,267	3,890	4,727
Net Worth	**2,292**	**2,837**	**3,395**	**4,019**	**4,856**
Deferred liabilities	223	250	282	372	445
Total Loans	659	661	1,653	1,708	1,297
Capital Employed	**3,174**	**3,748**	**5,330**	**6,099**	**6,598**
Gross Block	2,236	2,538	3,138	4,138	4,438
Less: Accum. Deprn.	573	723	872	1,108	1,384
Net Fixed Assets	**1,663**	**1,815**	**2,266**	**3,030**	**3,055**
Capital WIP	55	11	63	83	89
Investments	1	0	750	320	500
Curr. Assets	**2,115**	**2,717**	**3,117**	**3,640**	**4,079**
Inventory	1,076	1,390	1,524	1,735	1,971
Account Receivables	867	1,022	1,258	1,431	1,626
Cash and Bank Balance	72	45	49	148	111
Loans & Advances	100	260	286	325	370
Curr. Liability & Prov.	**660**	**795**	**866**	**974**	**1,124**
Account Payables	532	678	686	781	887
Provisions	128	117	180	193	237
Net Current Assets	**1,455**	**1,922**	**2,251**	**2,666**	**2,954**
Appl. of Funds	**3,174**	**3,748**	**5,330**	**6,099**	**6,598**

E: MOSt Estimates

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Oper. Profit/(Loss) before T	1,041	1,046	1,167	1,324	1,589
Interest/Dividends Recd.	145	171	106	183	207
Direct Taxes Paid	-243	-330	-333	-249	-280
(Inc)/Dec in WC	-648	-493	-326	-315	-325
CF from Operations	**295**	**394**	**614**	**942**	**1,191**
EO Expense / (Income)	0	0	0	0	0
CF from Operating incl	**295**	**394**	**614**	**942**	**1,191**
(inc)/dec in FA	-340	-259	-651	-1,020	-306
(Pur)/Sale of Investments	0	1	-750	430	-180
CF from Investments	**-364**	**-263**	**-1,401**	**-590**	**-486**
Issue of Shares	0	1	0	0	0
(Inc)/Dec in Debt	225	2	992	55	-411
Interest Paid	-34	-43	-56	-140	-122
Dividend Paid	-116	-117	-146	-168	-209
Others	20	0	0	0	0
CF from Fin. Activity	**96**	**-158**	**790**	**-253**	**-742**
Inc/Dec of Cash	**27**	**-27**	**4**	**100**	**-37**
Add: Beginning Balance	45	72	45	49	148
Closing Balance	**72**	**45**	**49**	**148**	**111**

NOTES

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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