

### In-line 1Q, backward integration to lead all the way

Divi's reported an in-line Q1 despite a beat on margins due to higher tax spend. Sales grew 13% YoY, 10% QoQ at Rs196bn. Healthy gross margins at 67% (backward integration coupled with better process technology reduces dependency) and better product mix (Generic and Custom Synthesis contributed 50% each with Custom Synthesis also recording Molnupiravir sales in Q1, we estimate Rs2bn) aided margins at 43.5% vs our expectation of 40.5%. Adjusting for forex loss of Rs190mn, PAT came in at Rs5.4bn exactly in line with our estimates. Divi's highlighted 6 key growth engines that would continue to drive 10-15% revenue growth in the medium term with sustained margins. Capex for the current growth drivers is already in the last stage and progressing well. Key point to note is that management remains confident on future of generic APIs and believes that end-to-end integration coupled with better process technology are its key success levers.

**Key triggers:** (1) Raw material dependency lowered significantly due to backward integration process, further scope to reduce China dependency (2) Earmarked capex of Rs3.7bn to generate 2x asset turn (Rs1.8bn started from FY18, Rs0.4bn for custom synthesis and Rs1.5-2bn for Kakinada and Krishnapatnam greenfield projects) (3) 6 growth engines: established generics (MS>70%), new generics (capacity increased), newer molecules like contrast media API, added 16 new generic APIs to lead next phase of growth, 2 big long term custom synthesis projects on fast track and to add new molecules in sartans (edge over NDMA issues for other players), (4) Molnupiravir API supplies.

**Key Risks:** Decline in tonnage requirements of NCEs in custom synthesis segment could bring down the addressable opportunity size.

**Outlook and Valuation:** 1Q was yet again a strong quarter driven by volume growth across the product portfolio. After 4 flat quarters on top-line front (QoQ), 10% QoQ growth in Q1 is a respite. With significant capacity addition, we believe Divi's is well positioned to gain share from competitors in existing products, particularly, given the ongoing shift from China. Divi's asset base has doubled over last 3 years. FY21 gross asset turn is at 1.6x vs FY19 peak of 1.9x. After funding of Rs50bn of cumulative capex over last 10 years (>50% in last 3 years), Divi's generated Rs42bn cumulative free cash in 10 years, ~25% in FY21 alone.

### Q1FY22 Result (Rs Mn)

Particulars	Q1FY22	Q1FY21	YoY (%)	Q4FY21	QoQ (%)
Revenue	19,606	17,305	13.3	17,882	9.6
Total Expense	11,086	10,304	7.6	10,719	3.4
EBITDA	8,521	7,001	21.7	7,163	19.0
Depreciation	733	562	30.4	701	4.5
EBIT	7,788	6,439	21.0	6,462	20.5
Other Income	360	173	107.6	235	52.9
Interest	3	2	21.7	2	33.3
EBT	8,145	6,610	23.2	6,695	21.7
Tax	2,574	1,689	52.4	1,675	53.7
RPAT	5,571	4,921	13.2	5,020	11.0
APAT	5,441	4,885	11.4	4,991	9.0
			(bps)		(bps)
Gross Margin (%)	67.2	63.0	422	67.5	(24)
EBITDA Margin (%)	43.5	40.5	300	40.1	340
NPM (%)	28.4	28.4	(2)	28.1	34
Tax Rate (%)	31.6	25.6	604	25.0	658
EBIT Margin (%)	39.7	37.2	251	36.1	359

CMP	Rs 4,916
Target / Upside	Rs 5,400 / 10%
NIFTY	16,238
<b>Scrip Details</b>	
Equity / FV	Rs 531mn / Rs 2
Market Cap	Rs 1,305bn
	USD 17.5bn
52-week High/Low	Rs 5,045 / 2,722
Avg. Volume (no)	540,296
Bloom Code	DIVI IN
<b>Price Performance</b>	
	1M 3M 12M
Absolute (%)	9 22 77
Rel to NIFTY (%)	6 12 34

### Shareholding Pattern

	Dec'20	Mar'21	Jun'21
Promoters	52.0	52.0	52.0
MF/Banks/FIs	25.6	24.5	21.8
FII	20.4	19.9	20.6
Public / Others	2.1	3.7	5.7

### Valuation (x)

	FY21E	FY22E	FY23E
P/E	65.8	54.9	46.0
EV/EBITDA	44.9	37.3	30.9
ROE (%)	23.9	24.2	24.9
RoACE (%)	22.9	23.3	24.0

### Estimates (Rs mn)

	FY21E	FY22E	FY23E
Revenue	69,694	85,035	100,162
EBITDA	28,599	34,175	40,674
PAT	19,843	23,777	28,371
EPS (Rs.)	74.8	89.6	106.9

**VP - Research: Sapna Jhawar**

Tel: +9122 40969724

E-mail: sapnaj@dolatcapital.com

**Associate: Zain Gulam Hussain**

Tel: +9122 40969725

E-mail: zain@dolatcapital.com

**Exhibit 1: Revenue breck-up**

(Rs mn)	Q1FY22	Q1FY21	YoY (%)	Q4FY21	QoQ (%)	FY20	FY21	YoY (%)
Generic API	9,803	8,934	9.7	10,729	(8.6)	47,633	40,367	18.0
Custom Synthesis	8,423	7,104	18.6	5,595	50.6	28,058	23,382	20.0
Nutraceuticals	1380.0	1267.0	8.9	1558.0	(11.4)	7015.1	5945.0	18.0
Total Sales	19,606	17,305	13.3	17,882	9.6	82,707	69,694	18.7

Source: DART, Company

With capacity related bottlenecks now addressed, Divi's has also identified 6 engines to drive 10-15% growth in the medium term. We expect strong market share gains and introduction of new APIs to drive robust 20% sales/PAT CAGR each over FY21-23E. We remain constructive on EBITDA margin sustenance at ~40% over next 2 years despite incremental costs from newly commissioned capacities. Divi's is trading at 46x FY23E, its growth justifying the premium valuations vs peers. Our SOTP based target price of Rs5,400 values it at 50x.

### Key Con-call takeaways

- 1) **6 growth engines:** Divi's highlighted 6 key engines that would drive 10-15% growth over the next few years. Capex for these growth engines are already in place.
  - a. **Established generics:** Products where Divi's has >70% market share and will continue to grow ~10%. Divi's enjoy 70-90% market share in products like Naprozen, Gabapentin, Dextromethorphan
  - b. **Increased capacity utilization of existing generics:** Products where market share is ~20-30% target is to achieve 60-70% MS via higher capacity utilization
  - c. **Sartan APIs:** Divi's is end-to-end integrated for sartans which gives it a competitive edge over other players in terms of cost as well as NDMA impurities. Company plans to enter into newer sartans as well.
  - d. **Contrast Media:** Divi's aims to become the largest player in contrast media APIs. It has signed new contracts with innovators and expects good growth over next 2 years.
  - e. **Custom Synthesis:** Divi's signed 2 new long term contracts with innovators to be completed on a fast track basis.
  - f. **New generics:** Company has identified 16 new molecules (large volume but niche molecules) whose patents are set to expire over FY22-26.
- 2) **Capex Update:** Its planned capex of Rs37bn is progressing well with
  - a. Majority debottlenecking capex of Rs4bn completed and ~80% of capacity is utilized currently. This has reduced dependency on KSMs from China
  - b. Since 2018, Divi's has undertaken capex of Rs25bn of which Rs18bn is operational and revenue generating, another Rs5bn capex is in validation stage
  - c. Capitalized assets of Rs2.7bn in Q1
  - d. Supreme Court has given final approval in favour of Divi's for its Kakinada plot. Work should resume by end of Q2, so far company has invested Rs1.8bn at Kakinada. Will re-assess its filings from here and invest ~Rs1-2bn for Kakinada and Krishnapatnam port greenfield projects.

- 3) **Molnupiravir:** Divi's is one of the largest authorized supplier for Merck in the US, EU and other regulated markets. Divi's is also allowed to supply Molnupiravir API to MSD's licensed partners for India and 103 other LMICs. Our analysis suggests Divi's could achieve Rs10bn of Molnupiravir sales in FY22E (Q1 estimated sales is Rs2bn). One stream has already started producing Molnupiravir and the second stream validation is completed and is ready for commercial supplies. Molnupiravir API from these two streams would be exported directly to Merck. In addition, Divi's has created an additional stream at Unit 1 to supply the API to Merck's LMIC partners (Sun Pharma, Dr. Reddy's, Cipla, Hetero Labs and Encure).
- 4) **Logistics challenge:** Management admitted that it was facing some hiccups in supply chain but end-to-end integration aided in smoothening the process. Majority issues faced in areas of raw materials, solvents and export batches. **In order to overcome these challenges, it is now arranging for raw materials from EU and US by paying ~10-15% higher cost. With strong balance sheet and no working capital issues it can easily afford higher input costs without impacting growth.**
- 5) **Revenue mix:** In 1Q, API:CS ratio was split as 50:50 with nutraceuticals generating revenue of Rs1.38bn. Company guided that an ideal mix should likely be at 50:50 from Generics and CS, however, this might take few years. Currently top 5 products contribute around 47% to revenues of which top 2 products, Naproxen and Dextromethorphan account for 25% of sales. As far as geography wise mix is concerned, Divi's generated 71% of sales from US and EU in FY21. Total exports contribution is 89% in Q1FY22.
- 6) **Generic API:** As large part of the capacity expansion is complete; management remains optimistic of strong growth sustenance in API in FY22E even for its top 5 molecules. It has commenced supplies from blocks which are FDA approved post the expansion. Further, management has identified 16 new molecules for future growth (some of them are yet to go off-patent in 2025), addressable market opportunity of US\$12bn. Validations for 3 APIs is completed and company is preparing for DMF filings. 3 are under validation, 7 have samples and 3 are under in early stage of development. Currently it has around 30 products in the Generic API portfolio and is amongst the top 2 producers in 18 of the 30 APIs. **Despite being older products (>25 years), Divi's continue to cater to 60-90% of several APIs across the world and hence able to command premium vs competitors. Management believes that opportunity on few APIs is still 2-3x from here. Generic API market is growing at 5-7% p.a.**
- 7) **Custom Synthesis:** Divi's highlighted that it has not witnessed any slowdown in clinical activities during COVID. In-fact the enquiries for CS projects have been on the higher side as innovators across the globe are working on COVID products. Its Rs4bn capex is progressing well and production has started at one of the blocks. As Divi's offers largely phase 2 and 3 and launch commercial supplies, we expect the current order-book could add a hefty chunk of growth leading the way for Divi's. Management expects the all facilities to be up and running by 2HFY22E.
- 8) **Nutraceutical:** Nutraceuticals is now 10% of total sales with ~95% of its sales coming from US and EU. Company is seeing opportunities in this segment and has doubled its production capacity given the strong demand visibility. Carotenoid global market size is US\$1.5bn and is expected to grow at CAGR of 4% over FY19-26E. **Divi's is backward integrated for the production of API and finished forms of carotenoid, with a full-fledged R&D, application testing, and support facility under one roof at the Unit II facility. Its competitors produce APIs and finished forms at different locations, hence, they have a higher cost profile.**

**Profit and Loss Account**

(Rs Mn)	FY20A	FY21E	FY22E	FY23E
<b>Revenue</b>	<b>53,944</b>	<b>69,694</b>	<b>85,035</b>	<b>100,162</b>
<b>Total Expense</b>	<b>35,723</b>	<b>41,095</b>	<b>50,860</b>	<b>59,488</b>
COGS	21,085	23,241	28,972	33,449
Employees Cost	6,211	8,258	10,117	11,906
Other expenses	8,427	9,596	11,771	14,133
<b>EBIDTA</b>	<b>18,222</b>	<b>28,599</b>	<b>34,175</b>	<b>40,674</b>
Depreciation	1,862	2,556	3,077	3,500
<b>EBIT</b>	<b>16,359</b>	<b>26,044</b>	<b>31,099</b>	<b>37,174</b>
Interest	61	9	7	5
Other Income	1,896	626	683	746
Exc. / E.O. items	0	0	0	0
<b>EBT</b>	<b>18,195</b>	<b>26,660</b>	<b>31,774</b>	<b>37,914</b>
Tax	4,429	6,818	7,998	9,543
RPAT	13,765	19,843	23,777	28,371
Minority Interest	0	0	0	0
<b>Profit/Loss share of associates</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>APAT</b>	<b>14,387</b>	<b>19,843</b>	<b>23,777</b>	<b>28,371</b>

**Balance Sheet**

(Rs Mn)	FY20A	FY21E	FY22E	FY23E
<b>Sources of Funds</b>				
Equity Capital	531	531	531	531
Minority Interest	0	0	0	0
Reserves & Surplus	72,568	92,415	103,234	123,372
<b>Net Worth</b>	<b>73,099</b>	<b>92,946</b>	<b>103,765</b>	<b>123,903</b>
Total Debt	336	4	4	4
Net Deferred Tax Liability	3,014	3,695	4,097	4,529
<b>Total Capital Employed</b>	<b>76,450</b>	<b>96,645</b>	<b>107,865</b>	<b>128,436</b>

**Applications of Funds**

Net Block	<b>27,768</b>	<b>36,996</b>	<b>41,919</b>	<b>44,419</b>
CWIP	9,248	7,149	3,596	1,819
Investments	1,190	1,295	1,295	1,295
<b>Current Assets, Loans &amp; Advances</b>	<b>47,152</b>	<b>62,300</b>	<b>72,812</b>	<b>93,990</b>
Inventories	18,639	21,452	22,166	24,259
Receivables	14,134	16,765	18,479	20,387
Cash and Bank Balances	1,226	21,560	29,177	46,098
Loans and Advances	354	553	680	800
Other Current Assets	3,086	1,969	2,310	2,446
<b>Less: Current Liabilities &amp; Provisions</b>	<b>8,907</b>	<b>11,096</b>	<b>11,758</b>	<b>13,089</b>
Payables	5,907	7,632	8,062	9,283
Other Current Liabilities	3,000	3,464	3,696	3,806
<i>sub total</i>				
Net Current Assets	38,244	51,204	61,054	80,902
<b>Total Assets</b>	<b>76,450</b>	<b>96,645</b>	<b>107,865</b>	<b>128,436</b>

E – Estimates

**Important Ratios**

Particulars	FY20A	FY21E	FY22E	FY23E
<b>(A) Margins (%)</b>				
Gross Profit Margin	60.9	66.7	65.9	66.6
EBIDTA Margin	33.8	41.0	40.2	40.6
EBIT Margin	30.3	37.4	36.6	37.1
Tax rate	24.3	25.6	25.2	25.2
Net Profit Margin	25.5	28.5	28.0	28.3
<b>(B) As Percentage of Net Sales (%)</b>				
COGS	39.1	33.3	34.1	33.4
Employee	11.5	11.8	11.9	11.9
Other	15.6	13.8	13.8	14.1
<b>(C) Measure of Financial Status</b>				
Gross Debt / Equity	0.0	0.0	0.0	0.0
Interest Coverage	268.2	2993.5	4442.7	7080.7
Inventory days	126	112	95	88
Debtors days	96	88	79	74
Average Cost of Debt	8.8	5.1	200.0	150.0
Payable days	40	40	35	34
Working Capital days	259	268	262	295
FA T/O	1.9	1.9	2.0	2.3
<b>(D) Measures of Investment</b>				
AEPS (Rs)	54.2	74.8	89.6	106.9
CEPS (Rs)	61.2	84.4	101.2	120.1
DPS (Rs)	38.6	20.0	22.0	24.2
Dividend Payout (%)	71.2	26.8	24.6	22.6
BVPS (Rs)	275.4	350.1	390.9	466.8
RoANW (%)	19.3	23.9	24.2	24.9
RoACE (%)	18.5	22.9	23.3	24.0
RoAIC (%)	22.2	34.7	40.4	46.2
<b>(E) Valuation Ratios</b>				
CMP (Rs)	4916	4916	4916	4916
P/E	90.7	65.8	54.9	46.0
Mcap (Rs Mn)	1,304,952	1,304,952	1,304,952	1,304,952
MCap/ Sales	24.2	18.7	15.3	13.0
EV	1,294,349	1,283,395	1,275,778	1,258,858
EV/Sales	24.0	18.4	15.0	12.6
EV/EBITDA	71.0	44.9	37.3	30.9
P/BV	17.9	14.0	12.6	10.5
Dividend Yield (%)	0.8	0.4	0.4	0.5
<b>(F) Growth Rate (%)</b>				
Revenue	9.1	29.2	22.0	17.8
EBITDA	(2.7)	57.0	19.5	19.0
EBIT	(3.9)	59.2	19.4	19.5
PBT	(1.9)	46.5	19.2	19.3
APAT	6.4	37.9	19.8	19.3
EPS	6.4	37.9	19.8	19.3

**Cash Flow**

(Rs Mn)	FY20A	FY21E	FY22E	FY23E
CFO	13,256	20,839	25,029	29,382
CFI	(598)	1,733	(4,447)	(4,223)
CFF	(12,584)	(2,238)	(12,965)	(8,238)
FCFF	12,657	22,572	20,582	25,159
Opening Cash	1,153	1,226	21,560	29,177
Closing Cash	1,226	21,560	29,177	46,098

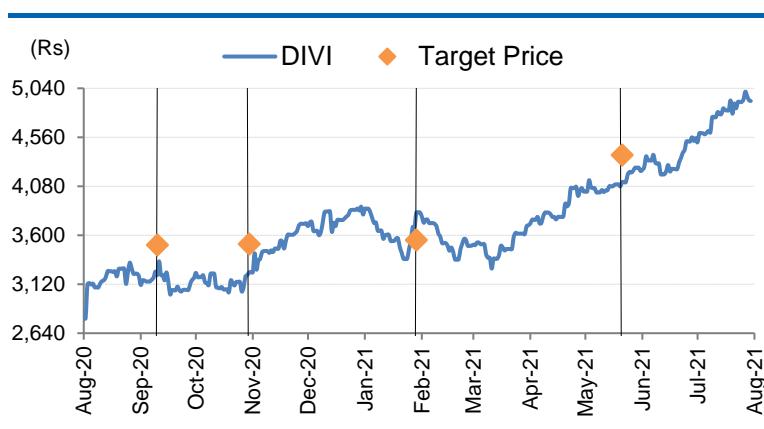
E – Estimates

### DART RATING MATRIX

Total Return Expectation (12 Months)

Buy	> 20%
Accumulate	10 to 20%
Reduce	0 to 10%
Sell	< 0%

### Rating and Target Price History



Month	Rating	TP (Rs.)	Price (Rs.)
Sep-20	Accumulate	3,505	3,211
Nov-20	Accumulate	3,515	3,237
Feb-21	Accumulate	3,554	3,822
May-21	Accumulate	4,386	4,120

\*Price as on recommendation date

### DART Team

Purvag Shah	Managing Director	purvag@dolatcapital.com	+9122 4096 9747
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Amit Khurana, CFA	Head of Equities	amit@dolatcapital.com	+9122 4096 9745
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#### CONTACT DETAILS

Equity Sales	Designation	E-mail	Direct Lines
Dinesh Bajaj	VP - Equity Sales	dineshb@dolatcapital.com	+9122 4096 9709
Kapil Yadav	VP - Equity Sales	kapil@dolatcapital.com	+9122 4096 9735
Jubbin Shah	VP - Equity Sales	jubbins@dolatcapital.com	+9122 4096 9779
Yomika Agarwal	VP - Equity Sales	yomika@dolatcapital.com	+9122 4096 9772
Anjana Jhaveri	VP - FII Sales	anjanaj@dolatcapital.com	+9122 4096 9758
Lekha Nahar	AVP - Equity Sales	lekhana@dolatcapital.com	+9122 4096 9740
Equity Trading	Designation	E-mail	
P. Sridhar	SVP and Head of Sales Trading	sridhar@dolatcapital.com	+9122 4096 9728
Chandrakant Ware	VP - Sales Trading	chandrakant@dolatcapital.com	+9122 4096 9707
Shirish Thakkar	VP - Head Domestic Derivatives Sales Trading	shirish@dolatcapital.com	+9122 4096 9702
Kartik Mehta	Asia Head Derivatives	kartikm@dolatcapital.com	+9122 4096 9715
Dinesh Mehta	Co - Head Asia Derivatives	dinesh.mehta@dolatcapital.com	+9122 4096 9765
Bhavin Mehta	VP - Derivatives Strategist	bhavinm@dolatcapital.com	+9122 4096 9705

**Dolat Capital Market Private Limited.**

Sunshine Tower, 28th Floor, Senapati Bapat Marg, Dadar (West), Mumbai 400013

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SEBI Registration No: BSE - INZ000274132, NSE - INZ000274132, Research: INH000000685

Registered office: Unit no PO6-02A - PO6-02D, Tower A, WTC, Block 51, Zone-5, Road 5E, Gift City, Gandhinagar, Gujarat – 382355

Board: +9122 40969700 | Fax: +9122 22651278 | Email: research@dolatcapital.com | www.dolatresearch.com

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