Recommendation | BUY
Divi's Laboratories Ltd | Share Price Rs. 629/share
Market Capitalization Rs. 16,698 Cr
P/E Ratio 15X FY17

About Divi's Laboratories Ltd

With sales turnover of Rs. 4,064 Cr (as of FY17), Divi's Laboratories (DLL) is engaged in manufacturing of generic APIs, Nutraceutical, Custom Synthesis (CS) of APIs and Intermediates for innovator companies. DLL has 4 manufacturing units and 3 R&D centres spread across the states of Telangana and Andhra Pradesh. With a portfolio of 122 products across diverse therapeutic areas, DLL is one of the largest pharmaceutical companies in India. DLL's revenues are derived from custom synthesis of APIs/ intermediates for innovator companies, and generic exports.

Divis Labs Stock Analysis 2017

EXCLUSIVE

Value Creation Index Colour Code Guide

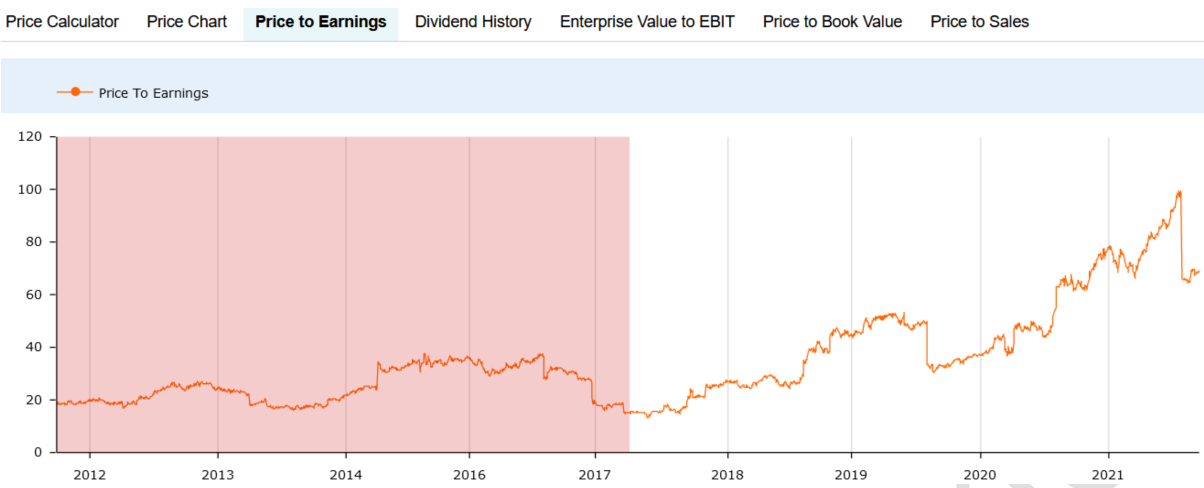
	Mar'08	Mar'09	Mar'10	Mar'11	Mar'12	Mar'13	Mar'14	Mar'15	Mar'16	Mar'17
Net Sales (Rs. Cr.)	1,035	1,183	944	1,317	1,864	2,145	2,532	3,115	3,776	4,064
Y-o-Y Gr. Rt.	-	14.30%	-20.21%	39.52%	41.53%	15.08%	18.04%	23.03%	21.22%	7.63%
Adjusted EPS (Rs.)	13.46	16.08	12.88	16.21	19.64	22.39	28.22	32.21	41.52	40.95
Y-o-Y Gr. Rt.	-	19.48%	-19.94%	25.90%	21.16%	14.00%	26.04%	14.14%	28.90%	-1.37%
Adjusted Net Profit	347.6	416.6	340.34	429.27	533	602	773.34	852	1,126	1,060
Net Op. Cash Flow (Rs. Cr.)	292	301	369	327	338	480	557	826	1,038	1,150
Debt to Cash Flow from Ops	0.16	0.07	0.03	0.03	0.04	0.03	0.08	0.11	0.03	0

CAGR	9 yrs	5 yrs	3 yrs	1 yr
Net Sales	16.41%	16.87%	17.08%	7.63%
Adjusted EPS	13.16%	15.83%	13.21%	-1.37%
Share Price	8.31%	11.16%	-1.59%	-34%

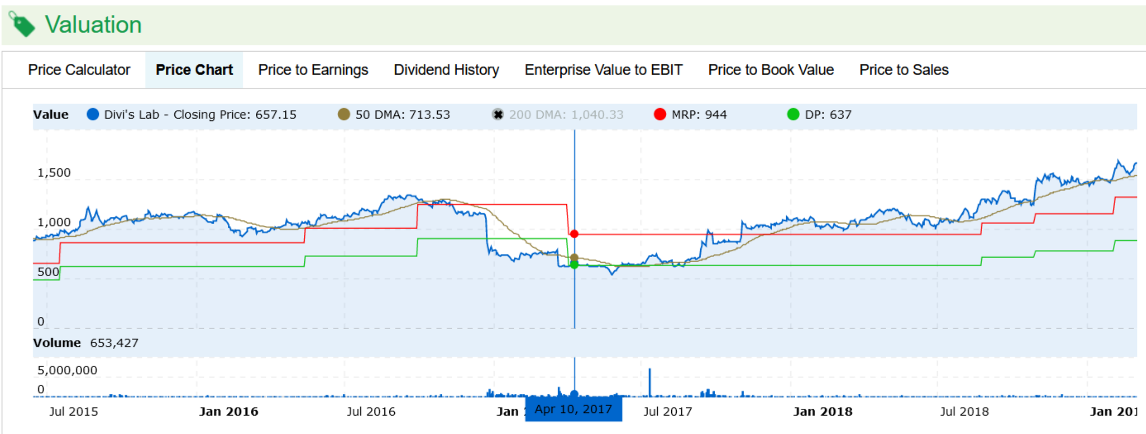
Key Financial Parameters	Mar'08	Mar'09	Mar'10	Mar'11	Mar'12	Mar'13	Mar'14	Mar'15	Mar'16	Mar'17
Return on Equity (%)	40.35	33.55	22.42	23.88	26.54	25.67	27.42	26.48	28.3	22.53
Operating Profit Margin (%)	40.61	43.71	42.99	38.04	37.14	38.08	40.2	37.67	37.67	36.64
Net Profit Margin (%)	33.58	35.21	36.05	32.6	27.97	27.72	29.58	27.45	29.19	26.74
Debt to Equity	0.03	0.01	0.01	0.01	0.01	0.01	0.01	0.02	0	0

Refer to our Divi's Laboratories Price Tab which includes all Valuation ratios:

Divi's Laboratories was trading at lower end of Price to Earnings ratio, a very common valuation tool used for API companies with higher margins.



You did not have to look at Price/Earnings ratio but follow our MRP/DP.



You would have seen the price was below MRP from November 2016 to September 2017. Since that point, the stock returns 700%.

Our MRP showed Rs. 944/share as fair price and Rs. 637 as Discounted Price. Upside Potential from this price was More than 15% CAGR

What would have given you more confidence on Divi's Laboratories future prospects?

Analyst note in Apr 2017

- In past, the management has also mentioned that since fixed costs don't grow over years' operating from same facilities, margins tend to increase slightly with increase in sales. This gives us evidence of why the company has had increasing margins. Within that, the custom synthesis products have better margins as compared to API. We believe that in such situations clients would also help company to resolve issues or approach USFDA for some more exemptions.
- We estimate that the downside from USFDA ruling is not a big dent on Divis. It will not lead to losses but shrinkage in margin due to lower asset turnover and higher remediation costs. EBITDA may go down to 25-28%. Assuming that Europe regulatory won't rule similar import alert, this seems to be a good price to enter.

Concerns

- Divi's is expecting USFDA inspection on its Unit 1 facility. If similar observations are repeated, it may signal systematic failure. As of now, European regulatory review is not definite. As mentioned in our earlier note dated as on 22 Mar 2017, Import alert from European regulatory is likely to hit revenues and profitability to Divis. This may lead us moving out of stock too. Then the valuation may move further down to Rs 300-400/share i.e. downside of 36%. However, upside risk is that even EU authorities will grant some exemptions which will not lead to further drawdowns on revenues.

As far as client's withdrawal of contracts, the management has mentioned in previous annual reports that they have diverse clients and not all of them will quit association unless their ingredients requirement is unfulfilled despite USFDA exemptions.

- The management recently interacted with analysts and investors on a conference call. They are estimating the sale impact not exceeding 5% of overall sales. This has caused our earlier estimates to change a bit though our hypothesis remains intact. We may not see significant hit on revenue numbers but lower asset turnover and higher compliance cost may result to lower margins. EBITDA and NPM may go down to 30-32% and 22-25% respectively during the remedial period.

What should investors do?

- We are recommending buying the stock very slowly starting at Rs. 630-650/share. We will restrict our exposure to just 3% of portfolio much lesser than our usual allocation. Only uncertain events throw up undervalued opportunities. But at the same time, we should be cautious and implement strict risk control. Hence we will be buying only 3% of portfolio. If worst case scenario pans out, we may lose small 1% point on portfolio level. In base and best case scenario, we may earn 15 or 20% CAGR over 5 years resp. This is a typical situation which investor Mohnish Pabrai describes, "Heads I win, tails I don't lose much."

- Media and TV analysts might be talking very negatively about the stock prospects in near future. But we have ignored stock price related noise and focus on core business. We will be monitoring our position and wait for future 2-3Q results. Stock may be volatile over few quarters till clarity emerges. We will take position now because after clarity stock will run up and it will no more be a bargain.

About MoneyWorks4me

MoneyWorks4me, through its parent company The Alchemists Ark Private Ltd, is SEBI registered Investor Advisor**INA000013323.** With MoneyWorks4me you can build strong stocks portfolio by buying quality stocks only at reasonable price. We help you with recommendations, research, insights and advice through your investment journey. Take control of your investments and make informed decisions because investing is too important to fail.

END