| April 20, 2022 | PICK OF THE MONTH | VOL-8, NO-07 |
|---|---|---|
| Industry: Pharmaceuticals | Divi's Laboratories Limited | BUY |
| CMP: Rs.4402 | TARGET PRICE: Rs.5206 | TIME : 12 months |

**The Active Pharmaceutical Ingredients (APIs) Industry:** APIs are considered as the foundational blocks in the pharmaceutical value chain. Being of strategic importance; on an average generally the API contribution to the overall cost stands approximately at 40% but this can even inch upto 70-80% depending on the prevailing API prices. Recently, the API prices have increased from 11% to 51% and excipients from 11% to 61%. The API market was valued at ~USD177.05bn in 2021, and it is expected to reach USD258.60bn by 2027, registering a CAGR of nearly 7.50% during the forecast period 2022-2027. The Indian APIs market stood at USD11.80bn in FY21 and is expected to grow at a CAGR of 12.24% during the forecast period (2021-2027). As per IMS 2020, the generic market for API has a share of 94% by volume with the innovator's share of 6%; marking an immense growth in the generics market.

**The Past:** China has seen a drastic movement in its position in the pharmaceutical market; i.e. from 09th position in 2007 to being second largest at present, next only to the US. The Chinese pharma industry undertakes production of basic chemicals and APIs (regarded as the global leader in production and exports of APIs with a share of ~20% of the total global API output). On account of the competitive pricing offered by the Chinese suppliers, dependency on China for APIs has emerged as a major concern for the Indian pharma industry. As per PwC Report, the import percentage has spiked to almost 78% in 2020 from a mere 0.5% back in 1987. This relative advantage towards the Chinese players is attributed to positive factors such as scale, subsidies, cheaper capital, lower logistics cost, govt. support for manufacturing, lower capex requirements due to large SEZs, etc. to mention a few.

**The Present:** The Indian pharma industry has been struggling since long owing to the dependency on a single geography for its API requirements (which has been facing price volatility over and above other emergency-like situations). It is believed, that the pandemic turned out to be an eye-opener for the Indian pharma industry. India's move to challenge and overcome the Chinese dominance has pushed the GOI to escalate the domestic production. In the purview of the same, the GOI had rolled out a PLI scheme in July, 2020 for critical bulk drugs with a total outlay of Rs69.4bn; for which the government received a total application from 215 pharma players till April 2021; approved list stood at 47 with a committed investment of Rs53.6bn. The main motive of this roll-out was to enable in-house production in the pharma sector and enhance the manufacturing capabilities of the Indian pharma players. As per the findings from The United States Pharmacopeia (USP) Report, over 80% of all the APIs needed for essential medicines in the US are being catered by API manufacturing facilities from India and China. According to the USP, of the 342 manufacturing facilities worldwide with more than 10 active US-approved API products, more than half are based in India. Of those with more than 30 active US-approved API products, India accounts for 65%. According to an analysis of FDA data of 2021, manufacturing delays accounted for 11% of all drug shortages in the US. Ingredient shortages were ~5% of the drugs reported to be in short supply. All of this further raises an optimism of India trying its upper edge and having a better image in the pharma sector.

**Exhibit 01: No. of Active Manufacturing US Approved Facilities**

| Region | More than 30 active US approved API products | More than 10 active US approved API products |
|---|---|---|
| India | 114 | 183 |
| European Region | 45 | 83 |
| China | 4 | 35 |
| United States | 3 | 19 |
| Other | 7 | 22 |

*Source: /us-pharmacopeia-report-high-reliance-indian-manufacturers-api/, Progressive Research*

| SNAPSHOT | |
|---|---|
| 52 week H / L | Mcap (INR mn) |
| 5425/3742 | 1,168,672 |
| Face value: 2 | |
| BSE Code | NSE CODE |
| 532488 | DIVISLAB |

**Annual Performance**

| (Rs mn) | FY19 | FY20 | FY21 | FY22E |
|---|---|---|---|---|
| Total Revenue | 49,463 | 53,944 | 69,694 | 89,415 |
| EBITDA | 18,718 | 18,222 | 28,599 | 38,001 |
| EBITDA (%) | 37.8 | 33.8 | 41.0 | 42.5 |
| Other Income | 1,556 | 1,896 | 626 | 848 |
| Interest | 35 | 61 | 9 | 11 |
| Depreciation | 1,689 | 1,862 | 2,556 | 3,189 |
| PBT | 18,551 | 18,195 | 26,660 | 35,650 |
| PAT | 13,527 | 13,765 | 19,843 | 27,985 |
| Equity ( Rs mn) | 531 | 531 | 531 | 531 |
| EPS (INR) | 51 | 52 | 75 | 105 |

**Quarterly Performance**

| Parameters (Rs mn) | Mar-21 | Jun-21 | Sept-21 | Dec-21 |
|---|---|---|---|---|
| Sales (Net) | 17,882 | 19,606 | 19,875 | 24,932 |
| EBITDA | 7,163 | 8,521 | 8,181 | 10,972 |
| EBITDA (%) | 40.1 | 43.5 | 41.2 | 44.0 |
| Other Income | 235 | 360 | 191 | 166 |
| Interest | 2 | 3 | 2 | 2 |
| Depreciation | 701 | 733 | 774 | 799 |
| PAT | 5,005 | 5,589 | 6,066 | 9,029 |
| Equity ( Rs mn) | 531 | 531 | 531 | 531 |

**Ratio Analysis**

| Parameters (Rs mn) | FY19 | FY20 | FY21 | FY22E |
|---|---|---|---|---|
| EV/EBITDA (x) | 62.5 | 64.1 | 40.2 | 30.2 |
| EV/Net Sales (x) | 23.6 | 21.7 | 16.5 | 12.8 |
| M Cap/Sales (x) | 23.6 | 21.7 | 16.8 | 13.1 |
| M Cap/EBITDA (x) | 62.4 | 64.1 | 40.9 | 30.8 |
| Debt/Equity (x) | 0.06 | 0.06 | 0.05 | 0.04 |
| ROCE (%) | 27.9 | 24.7 | 30.9 | 33.8 |
| Price/Book Value (x) | 16.8 | 16.0 | 12.6 | 10.6 |
| P/E (x) (TTM) | 25.9 | 47.4 | 57.4 | 40.0 |

**Shareholding Pattern as on 31st March, 2022**

| Parameters | No of Shares | % |
|---|---|---|
| Promoters | 137,894,200 | 51.9 |
| Institutions | 97,617,999 | 36.8 |
| Public | 29,956,381 | 11.3 |
| TOTAL | 265,468,580 | 100.0 |

*Source: Annual Report, Progressive Research*

*Note: Data is calculated as on 19th April, 2022*

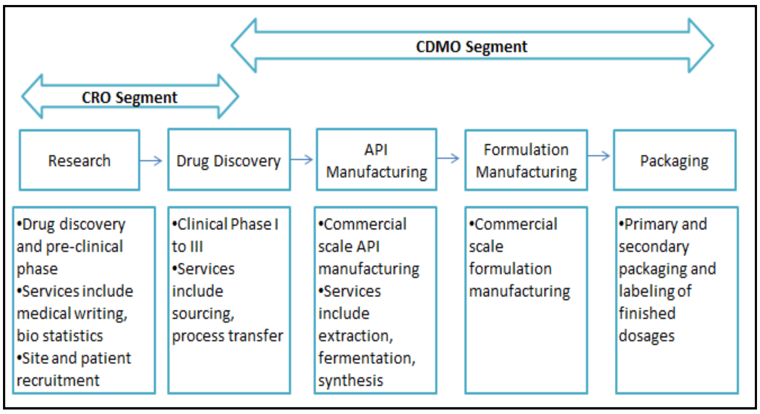
**Industry Overview (contd.):**

**Government Initiatives:** In order to have a conducive ecosystem and revive the API industry; there would be interventions needed by the government which would favour the industry sentiments. **Few of the initiatives are:** (i) Faster environmental clearance, (ii) Facilitate alternative import sourcing requirements, (iii) Encourage manufacturing by providing a fiscal stimulus, (iv) Accommodative pricing policy under DPCO, 2013

**Nutraceuticals:** *This is a broader term that caters to food or parts of food that provide incremental health benefits. These are derived from vitamins, minerals and plants with specific medicinal properties that assist in fighting against diseases and further enable to resist any sickness.* Nutraceuticals/Health supplements are further classified into **functional/fortified foods** (breakfast cereals, probiotic food like yoghurt), **functional beverages** (sports and energy drinks, juices) and **dietary supplements** (tonics, herbal and non-herbal extract). According to a report, the global nutraceuticals market size was valued at USD382.51bn in 2019 and is expected to expand at a CAGR of 8.3% over 2020-2027. The Indian nutraceuticals market accounts for around 2% of the global nutraceuticals market. The nutraceuticals market in India is expected to grow from USD4bn in 2017 to USD18bn in 2025. This comes in the backdrop of rising demand for dietary supplements. With increased importance towards being health conscious, the demand for nutrients and micro-nutrients based products like Vitamins (A, D and C), zinc, folate has increased substantially. The industry has seen a gradual uptick in the past few years with the recent boost observed during the pandemic. Despite the growth, the industry does face challenges and needs constant support from the government in the form of better regulations, taxes and rules. The PSA of India formed the first multi-ministry nutraceuticals taskforce along with key industry members to design policies that will enable the industry to achieve USD100bn opportunities by 2030.

**Custom Synthesis:** The companies having a large US generics portfolio exposure are venturing into niche opportunities in complex generics/specialty drugs, Contract Research and Manufacturing Services (CRAMS) for API/Formulations that are emerging opportunities for companies with a sound technical, manufacturing, and regulatory expertise. CRAMS has emerged as a niche segment, offering a high growth potential. According to Pharmabiz; the global CRAMS segment is expected to clock 6.2% CAGR over CY21-26E to achieve ~USD170bn. CRAMS includes **Contract Research Organization (CRO)** and **Contract Drug Manufacturing Organization (CDMO)**. Companies offering CRO services focus on research and drug discovery phases, with an offering in biochemistry, biology, data and statistical analysis, and regulatory filing services. Considering the rising needs of pharmaceuticals has led to an increased need for outsourcing drug development to the CDMOs. The API CDMO accounts for ~75% of the global CDMO market; attributed to a cost focused approach undertaken by both the generic and innovator companies. Many innovators have divested their API facilities to concentrate on the manufacture of formulations. This has resulted in a larger CDMO opportunity for API manufacturers. As per articles, over the past 5 years, the Indian formulations CDMO market has grown at 13% as against 8.6% growth rate of the domestic formulations market. Going forward, the domestic formulations by CDMOs are anticipated to grow at a CAGR of 14% by FY25E driven by a strong outsourcing demand from big pharma players (both at the Indian and global level) along with rising demand for generic products under the chronic therapeutic category. The Indian CRAMS players offer services right from the pre-clinical trials to manufacturing of finished dosages. India is considered of having a high quality, low cost talent which supports the drug discovery and research processes. Additionally, another biggest advantage of outsourcing to the Indian markets is the cost benefit (37.5% lower as compared to its competitive counterparts) compared to the United States and Europe. The Indian pharma companies are anticipating sustainable growth opportunities over the coming decades alongwith trying its hands on building a skill set to cater to the biologics and synthesis based CDMOs as well. As per Technavio, the biologics CDMO market is anticipated to grow by USD8.65bn from 2021 to 2026, CAGR of 12.2%. With a spurt of emerging Biopharma companies, developing ~3,500 recombinant proteins/antibodies and having limited manufacturing capabilities/capacity, it provides the right ingredient to partner with CDMO companies.

**Exhibit 02: CRO and CDMO Structure**




*Source: Crisil Report, Progressive Research*

| April 20, 2022 | PICK OF THE MONTH | VOL-8, NO-07 |
|---|---|---|
| Industry: Pharmaceuticals | Divi's Laboratories Limited | BUY |
| CMP: Rs.4402 | TARGET PRICE: Rs.5206 | TIME : 12 months |

**About the Company:** Established in 1990, Divi's Laboratories Limited (Divi's) is engaged in the manufacturing of generic APIs and intermediates, custom synthesis of active ingredients and advanced intermediates for pharma MNCs, other specialty chemicals like carotenoids and complex compounds like peptides and nucleotides. The company is recognised as a reliable supplier of generic APIs, a trustworthy custom manufacturer to big pharma and is among the top API manufacturers worldwide. It has six multi-purpose manufacturing facilities from two sites with all support infrastructures like utilities, environment management and safety systems. Divi's has two subsidiaries M/s. Divi's Laboratories (USA) Inc. in the US and M/s. Divi's Laboratories Europe AG in Switzerland for marketing its nutraceuticals products thus providing greater reach to customers within these regions. Dr. Murali K Divi is the Managing Director of the company.

**Exhibit 03: Milestone**

| Year | Key Achievements |
|---|---|
| 1990-95 | Establishment of Divi's Research Centre (DRC) for commercial processes and supplies to pharma companies |
| 2001-04 | Commenced new manufacturing facility Unit-2 near Vishakhapatnam |
| 2005-10 | Established new research centre in Hyderabad |
| 2011-15 | First EU GMP and Japan PMDA inspection, First TGA inspection, First COFEPRIS inspection |
| 2016-21 | 6th USFDA Inspection at Unit-2, expanded the product portfolio to over 30 products, additional investment of USD250mn towards product expansion |

*Source: Company Website, Progressive Research*

**Investment Rationale:**

**(A) Business Profile:** The company deals in manufacturing of APIs, intermediates and nutraceuticals ingredients. The business is categorized into **(i) Generic APIs**, *(contains the same chemical substance as a drug that was originally protected by chemical patents)* **(ii) Custom Synthesis** *(a process wherein a molecule is made exclusively for a particular customer as per their specifications)* and **(iii) Nutraceuticals** *(products that provide health benefits in addition to the basic nutritional value found in foods).* With regard to the revenue split (9MFY22), the broader bifurcation is Generics (50%), Nutraceuticals (7%) and Custom Synthesis (43%).

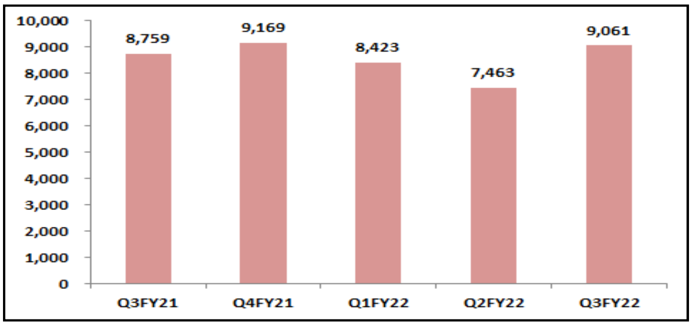
(i) Generic APIs: Divi's is a world leader in 11 out of the ~25-30 APIs produced by it; supplies 100s/1000s of tonnes every year to customers in more than 95 countries. It is one of the largest generic API companies in the world particularly in large volume APIs. Divi's is regarded as the reliable supplier of APIs having competitive pricing and ability to provide uniform quality for all its customers across the globe. The strategy has been to focus on limited products, build large capacities to gain scale & sizeable market share, continuous process improvement and robust chemistry skills to gain cost advantage and to have backward integration of intermediates for selected products. This strategy has clearly helped the company to witness constant strong growth momentum (19.8% revenue CAGR in generic APIs over the last 4 years). **Some of the leading commercial products for Divi's includes, Bupropion HCl (anti-depressant), Carbidopa (anti-parkinson), Gabapentin (neuropathic pain), Lacosamide (anti-convulsant), Molnupiravir (anti-viral), Pregabalin (anti-epileptic), Valsartan (anti-hypertensive)** to mention a few.

**Exhibit 04: Business Classification**

| Year | Generic APIs | Custom Synthesis | Nutraceuticals |
|---|---|---|---|
| FY18 | 49% | 44% | 7% |
| FY19 | 49% | 43% | 8% |
| FY20 | 51% | 41% | 8% |
| FY21 | 51% | 40% | 9% |
| 9MFY22 | 50% | 43% | 7% |

*Source: Market Reports, Progressive Research*

**Exhibit 05: Generic APIs Revenues (Rs mn)**




*Source: Quarterly concalls, Progressive Research*

(ii) Custom Synthesis: Divi's is engaged in custom synthesis (CRAMS) of APIs and intermediates that cater to global innovator companies across various therapeutic areas. This is the core business area contributing ~40% of the revenues. It primarily includes contract manufacturing services of API and intermediates for global innovators with a diverse product portfolio. Divi's enjoys a strong relationship with 12 out of the top 20 pharmaceutical companies across US, EU and Japan associated with it for more than a decade. This segment majorly involves associating with the innovator companies' projects at phase-II or phase-III level and supply materials for trials initially and later for commercial quantities if the product is successfully approved and launched.

| April 20, 2022 | PICK OF THE MONTH | VOL-8, NO-07 |
|---|---|---|
| Industry: Pharmaceuticals | Divi's Laboratories Limited | BUY |
| CMP: Rs.4402 | TARGET PRICE: Rs.5206 | TIME : 12 months |

## Investment Rationale (contd.):

### Exhibit 06: Commercialised Products

| Commercial Products | Therapeutic Area | Commercial Products | Therapeutic Area |
|---|---|---|---|
| Bupropion | Anti-depressants | Nabumetone | Anti-inflammatory |
| Capecitabine | Anti-neoplastic | Naproxen | Anti-inflammatory, Analgesic, Anti-pyretic |
| Carbidopa | Anti-parkinson | Naproxen Sodium | Anti-inflammatory, Analgesic, Anti-pyretic |
| Dextromethorphan Hbr. | Antitussive, Analgesic | Niacin | Anti-hyperlipidemic |
| Diltiazem Hcl | Anti-hypertensive | Orlistat | Lipase inhibitors |
| Gabapentin | Anti-convulsants/Neuropathic Pain | Phenylephrine Hcl | Antitussive |
| Iopamidol | Contrast Medium | Proguanil Hcl | Prophylactic anti-malarial |
| Irbesartan | Anti-hypertensive | Quetiapine Fumerate | Anti- psychotic |
| Lacosamide | Anti-convulsants | Triprolidine Hcl | Antihistamine |
| Levodopa | Anti-parkinson | Valacyclovir Hcl | Anti-viral |
| Mesalamine | Anti-inflammatory | Valsartan | Anti-hypertensive |
| Molnupiravir | Anti-viral | Venlafaxine Hcl | Anti-depressants |

*Source: Company's Product Catalogue, Dec 2021, Progressive Research*

(ii) Custom Synthesis (contd.): Stickiness is the advantage of this business as the innovator customer will want a reliable and quality supplier and won't move away generally as the product would initially be under patent. Hence, if the product is successfully launched, commercial supplies become more sustainable in nature. Divi's has an edge and possesses the decisive power when it comes to manufacturing of generic APIs; but as far as the custom synthesis is concerned, the company has to work and deliver the results as per the customers' requirements related to the quantity that is demanded and the supply time frame; which may portray a quarterly lumpiness effect (despite being high margin) in this business. From a growth perspective it would be apt to see the trend on a y-o-y basis. The Management is working towards making equal split in contribution from generics and custom synthesis. Additionally, around USD20bn worth of patents are anticipated to go off-patent in 2023-25, which would open up growth opportunity back again in the generics space. Divi's Q3FY22 sales increased 47% y-o-y (up 25% q-o-q) to Rs25bn, largely driven by strong growth in custom synthesis (up 120% y-o-y) on account of Molnupiravir sales. The future growth visibility of this business segment depends upon the R&D spend by the innovators, new product pipeline (i.e. NCEs) and innovative product approvals. The global R&D spend has been on a rise and as a percent to sales has been largely stable. Innovation is a constant feature in pharma and NCE pipeline of new drug development will continue to remain robust.

### Exhibit 07: Products Under Radar

| Products | Therapeutic Area | Status |
|---|---|---|
| Ticagrelor | Anti-coagulant | Launched |
| Iohexol | Contrast Medium | Validations completed |
| Dabigatran | Anti-coagulant | Validations completed |
| Brivaracetam | Anti-convulsants | Under validation |
| Rivaroxaban | Anti-coagulant | Under validation |
| Benserazide | Anti-parkinson | Under validation |
| Losartan | Angiotensin Receptor Blocker | Sample available |
| Mirabegron | Anticholinergic | Sample available |
| Vildagliptin | Anti-diabetic | Sample available |

*Source: Company's Product Catalogue, Dec 2021, Progressive Research*

(iii) Nutraceuticals: Divi's nutraceuticals is committed towards providing the highest quality of carotenoids and vitamin ingredient solutions. It has an integrated facility at Unit-II intended for production of active ingredient and finished forms of carotenoids *(these are beneficial antioxidants that protects one from diseases and enhances the immune system)*. The facility includes a full-fledged R&D, application testing and support facility. Divi's is involved in supply of carotenoids (Beta Carotene, Astaxanthin, Lycopene, Canthaxahnthin and also finished forms such as Lutein, Vitamins (A, D3, D2, E Acetate and A Palmitate) to all the major food, dietary supplement and feed manufacturers around the world. As the company manufactures all the products by itself, it controls the production chain and supply, ensuring full traceability of products and guarantee of quality. The business has reported revenues of Rs1,660mn in Q3FY22 and Rs4,710mn for 9MFY22. We expect the growth momentum to continue to drive through the rising demand for nutraceuticals products globally after Covid-19 outbreak. The Management has indicated a growth of roughly 10-15% in the near term.

### Exhibit 08: Nutraceuticals Products

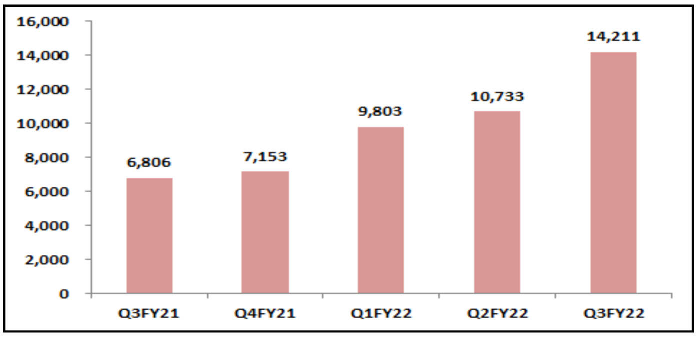
| Nutraceuticals | |
|---|---|
| Human Health | Animal Health |
| Beta-carotene | Astaxanthin |
| Lycopene | Canthaxanthin |
| Lutein | Beta-carotene |
| Apocarotenal | |
| Blends | |
| Canthaxanthin | |
| Vitamin D3 | |
| Vitamin A | |

*Source: Divi's Product Catalogue, Dec 2021, Progressive Research*

Overall, with the long standing expertise in active ingredients and product formulations, integrated manufacturing, compliant on the regulatory front; Divi's stands out as a reliable manufacturer and supplier of high quality ingredients in the nutraceuticals space of business.

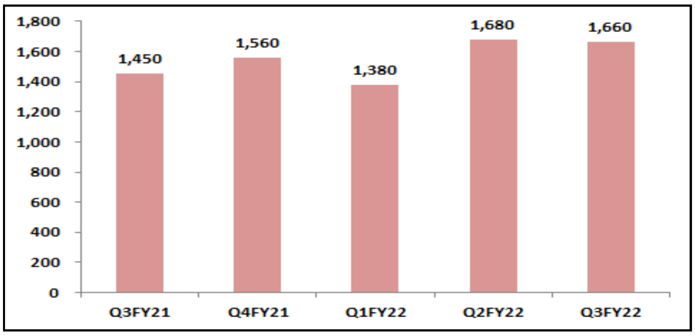
## Investment Rationale (contd.):

**Exhibit 09: Custom Synthesis Revenues (Rs mn)**




*Source: Quarterly Concalls, Progressive Research*

**Exhibit 10: Nutraceuticals Revenues (Rs mn)**



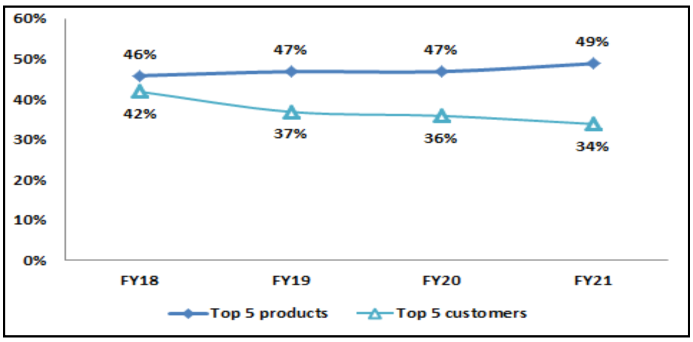

*Source: Quarterly Concalls, Progressive Research*

**(B) Growth Targets Set for Key Products/Businesses:** (i) Under the **custom synthesis** division; Divi's maintains a strong relationship with global pharma players, while in the generics space; it enjoys a significant market share in key products such as Naproxen, Dextromethorphan and Gabapentin among others. As per CARE Ratings, Naproxen contributed about 20% of the sales in FY21 as against 18% in FY20. In furtherance to this, Divi's has a significant market share in Dextromethorphan and Gabapentin. On a cumulative basis, the company enjoys ~65-70% market share in these drugs; wherein the traditional market for these drugs are witnessing a growth of 5-15% on a y-o-y basis attributed to the rise in global aging population that would demand for pain reliever/lifestyle medicines. Divi's aims to increase the capacities of its existing generic molecules (Pregabalin, Methylamine) having a 20-30% market share (Levodopa and Valsartan) and anticipates the same to reach levels of 60-70% over the next few years. The **pipeline includes** new generic molecules such as **Vildagliptin, Ticagrelor** with patents expiring in 2023-25. (These have a market size of USD20bn in dosage form). The company has been meticulously building capacities in few more niche APIs as per the evolving demand scenario in the backdrop of 'China plus one' opportunities.

(ii) **Venturing into Sartans:** Of all the hue and cry that was in the air in terms of an impurity in N-Nitroso-dimethylamine (NDMA) and many of its related compounds, together being termed as nitrosamines (strong carcinogens amongst animals and likely having the same effects even in humans) led to actions related to recalls, suspensions of contaminated batches, widespread testing of samples, and the introduction of sweeping new quality-control measures to prevent future contamination. *All sartans require a key starting material named as Ortho Tolyl Benzonitrile (OTBN); produced in-house by Divi's.* The ability to control the nitrosamine and azido impurity in the product; (a major concern of the USFDA) stands to advantage Divi's. The company is venturing into all the sartans (has Valsartan, Losartan products under its radar) and is already in large production for a few; with an aim to build a unique position in the near term.

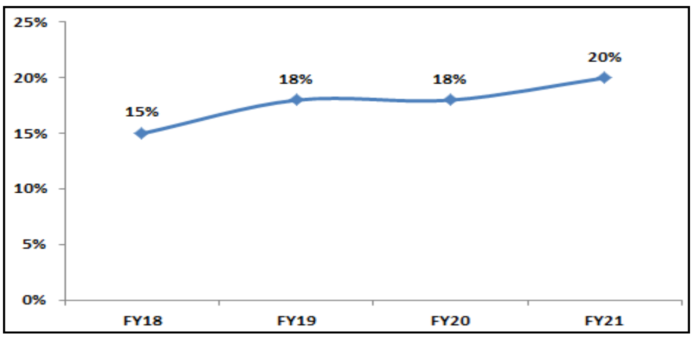
(iii) **Contrast Media:** Divi's is looking at contrast media manufacturing as a key growth driver, signing up with innovators and several big pharma players for the same. The Management anticipates next 2-3 years being a good growth journey in the contrast media space.

**Exhibit 11: Top 5 Products and Top 5 Customer Contribution**




*Source: Annual Reports, Progressive Research*

**Exhibit 12: Naproxen Revenue Contribution**




*Source: CARE Reports, Progressive Research*

**(C) Market Presence:** Divi's operations are more skewed towards the exports market; where it accounted for almost 87% of the total sales in FY21. Out of 87% exports contribution; majority of the revenue stream came in from Europe (contributed a share of 46% in FY21) and North American markets (24% in FY21). For 9MFY22, ~90% of the sales was reported as exports, while revenue contribution from the US and Europe collectively stood at 77%. The revenues for Divi's is well spread amongst its client portfolio with top 5 customers contributing ~34% of sales in FY21, top 5 products contributing 49% of sales in FY21 and largest product contributing around 20% in FY21.

**Investment Rationale (contd.):**

**(C) Market Presence (contd.):**

**Regulatory Approvals and Inspections:** The USFDA had conducted the inspection of the company's Unit I and II in November, 2019 and January, 2020 respectively with no critical observations being reported. Inspections were also undertaken by HPRA (Ireland) and JAZMP (Slovenia) at Unit II in August 2018 with no critical observations. In FY21, no inspections were carried out at the manufacturing facilities. As of FY21, the company has a total of 39 DMFs with the USFDA, 24 Certificate of Suitability (CEPs) and has filed for a total of 40 patents for generic products.

**(D) Molnupiravir Drug- Custom Synthesis:** In 2021, Merck (also known as MSD outside the US and Canada) announced of entering into a procurement agreement with the US government for Molnupiravir (MK-4482). *Molnupiravir is an oral antiviral for the treatment of mild to moderate Covid-19 in adults at high risk of severe disease. Molnupiravir is currently available by prescription only and with dosage initiated as soon as possible after Covid-19 diagnosis and within 5 days of symptom onset*. As per results from the interim analysis of Phase 3 trials in Oct 2021; the drug reduces the risk of hospitalisation/death by 50% for patients with mild to moderate Covid-19. Merck has also filed an Emergency Use Authorization (EUA) application to the USFDA for Molnupiravir on 11th Oct, 2021. Earlier in May 2021, Merck had signed an agreement with the US government to supply ~1.7 million courses of Molnupiravir upon issuance of a EUA or approval by the USFDA. Apart from being an authorized manufacturer of Molnupiravir API for MSD, the company is also MSD's custom synthesis partner that supplies the desired drug quantities during the clinical trials. As per media articles, Merck aims to manufacture 20 million doses of Molnupiravir in CY22 as against 10 million in CY21. For Divi's in specific, being involved in active ingredients, the company has the largest capacity at its disposal. Of the three streams lined up, one would be catering to the Indian markets, while the other two for exports. Divi's has garnered about 80% of the global market share in Molnupiravir API supply sales in FY22. Approximately USD250mn sales were undertaken by Divi's, higher than USD200mn earlier. Out of the 1700 reactors at present and assuming the utilization level of ~80-85%; the company still stands in a position to cater to about 250-300 reactors to accommodate the requirements for any of the APIs. Considering the possibilities of any new variants that would emerge or working on any combination drugs, Divi's is keeping a close watch on newer technologies; new chemistries that would be needed to quickly develop and manufacture/supply the same. As far as the capex requirements for Molnupiravir is concerned, the Management doesn't anticipate of incurring anything for atleast the next two quarters.

**(E) Production Linked Incentive (PLI) Benefits:** As per industry data statistics, import of API/bulk drugs and drug intermediates in FY21 came in at Rs285.29bn of which 68% or Rs194.02bn was imports from China. In order to de-risk from a single geography and to boost the domestic manufacturing of APIs; the government rolled out the PLI scheme for promotion of domestic manufacturing of critical key starting materials, drug intermediates and APIs. This included Rs150bn incentive on incremental sales to selected pharma participants for 6 years. Eligible drugs under the scheme included APIs among other categories of pharmaceutical products. A total of 278 applications were received as of 31st August, 2021, against which 55 applicants were selected under the scheme. Another scheme worth Rs69.40bn was launched for promoting domestic manufacturing of 41 critical drug intermediates and APIs as well. Growing demand for domestic manufacturing provides an uptick for a company like Divi's which has strong manufacturing capabilities. *Manufacturing of 35 active pharmaceutical ingredients, which have been imported earlier, has started in India under the production linked scheme for the pharmaceuticals sector. These 35 APIs are among the 53 APIs, for which India has 90% import dependence.* The company had undertaken 2 brownfield projects called DCV SEZ Unit at Chippada, Bheemunipatnam and DC SEZ Unit at Choutuppal, Nalgonda with an estimated investment of Rs600bn each (as per annual report 2021). Besides this, debottlenecking and backward integration at both the manufacturing sites were also a part of the plan. These programmes taken up during the last two years have become fully operational; and have reduced the company's dependency on KSM imports besides achieving productivity and cost efficiency. The enhanced backward integration has enabled the company to cut down on its imports percentage to 44% in FY21 as against 50% in FY20.

**Kakinada Manufacturing Unit:**

*In 2016, the Andhra Pradesh government had allotted 500 acres of land to the company near Kakinada in East Godavari district, as Divi's had sought to build a large plant (a greenfield project to make API and intermediates) close to the seacoast owing to logistic requirements. However, the site identified for this project is a part of a 2,000 acre piece of land that was acquired way back in 2008 by the Andhra Pradesh Industrial Infrastructure Corporation (APIIC) for the GMR Group. The Bengaluru-headquartered group was planning to develop a greenfield seaport on this land as a part of the 10,000 acre Kakinada SEZ (KSEZ) project. As per APIIC sources, the GMR group had agreed to part with this land for Divi's after the government promised to partly compensate for the loss in kind. The government had offered to provide an additional piece of 290 acres available in the adjoining area to the infrastructure major. GMR had already paid the money towards the land. Divi's had proposed to invest Rs7,500mn towards this project: Rs2,500mn in the first phase and Rs5,000mn in the second.*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**Investment Rationale (contd.):**

**Kakinada Manufacturing Unit (contd.):** As per latest updates, the operations at Kakinada East Godavari district were expected to commence within 12-18 months for Phase 1. The facility had been granted with all the necessary licenses awarded by the Centre and the Andhra Pradesh government to undertake the requisite implementation. Right after few days of commencement of the construction work, local protests, political issues and few of the industrial mishaps led to an unrest which made the local people skeptical over safety concerns; leading to a halt in the project work. As per Q2FY22 concall updates, all the cases imposed by the landlords for the 500 acre land are dismissed by the High Court and the State Government has fixed a price of Rs10 lakh per acre which the company has already paid. Divi's is waiting for the ownership transfer of the land from the APIIC. The company has the necessary blueprints and contractors all set and once the ownership is transferred, the construction work would start instantly. The Management anticipates a capex of ~Rs10-20bn for Kakinada and Krishnapatnam (Nellore) plants over the next 2-3 years.

**Financials:**

(a) Revenue growth over the years: Divi's has reported strong revenue CAGR of 21.4% over FY19-21 while a CAGR of 10.02% over the quarterly trend from Q3FY21-Q3FY22. These strong numbers are on account of a better product mix wherein the custom synthesis business has been the major contributor. Additionally, considering the strong opportunities, validations of several projects being underway both in custom synthesis and the generic portfolio indicate decent growth in the near term.

(b) Operational Efficiency: The Ebitda margins over the past 4-5 quarters have remained range bound at 40-44%. On the procurement, the energy crisis that took place in China; led to a significant increase in the raw material prices. The company however was able to mitigate few of the cost related pressures considering the diversified geographic base that Divi's caters to. The recent completion of backward integration of certain key products has enabled the company to reduce dependency on external raw material procurements; thereby helping it maintain the margins.

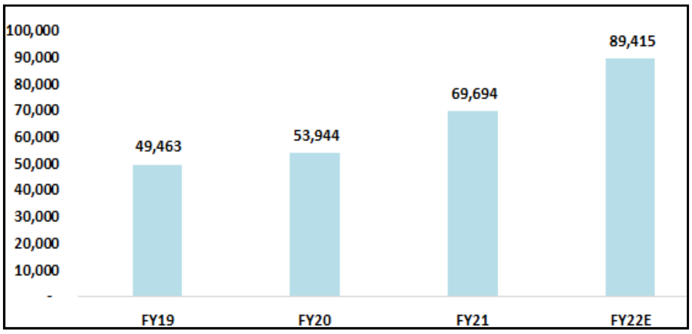
(c) Receding D/E ratio over the years: Divi's has made consistent efforts in debt repayment over FY18-21. As of FY21, the company has no debt in its books, rather only working capital which comprises of non-fund limits and minimal funded limits for operational needs. As on 31st December, 2021, the net cash position stood at Rs23,230mn.

(d) Focus remains on research: During the last three years, Divi's has incurred a total expense of Rs1241.3mn on R&D. The company has ~500 team members and 3 R&D centres. Emphasis on research has enabled Divi's achieve a leadership position in majority of its products. Roughly the R&D expense as a percentage of sales has remained at 0.75% over the last few financial years.

(e) Capex Plans: The company had earmarked an aggressive capex of ~Rs25bn (Rs18bn has been completed, balance Rs7bn is in validation/just completion stage) in FY18 including two brownfield projects, one each at Unit-I and Unit-II, capacity de-bottlenecking, backward integration and utilities modernization. Recent additions: A few additional blocks are planned for new major **custom synthesis** opportunities which are under construction and erection of equipment is on fast track. This investment is to the tune of Rs4bn (came into operations during March 2021, the Management anticipates to spend another Rs3bn during the second half of the financial year). Since these are just setting up of additional blocks, the expanded capacities don't need any further regulatory approvals. As reiterated earlier, Divi's is awaiting the ownership transfer of the land from the APIIC. The Management anticipates a capex of ~Rs10-20bn for **Kakinada and Krishnapatnam** plants in the next 2-3 years. These capex plans would add significant capacities and incremental revenues once fructified. During Q3FY22, the company achieved strong business continuity through completion of all the expansions to create a steady supply platform which would lead to minimizing supply risk, production disruption and adherence to delivery timelines. The company has capitalized Rs1,960mn in Q3FY22 and anticipating another Rs1,000mn capex to be capitalized in Q4FY22.

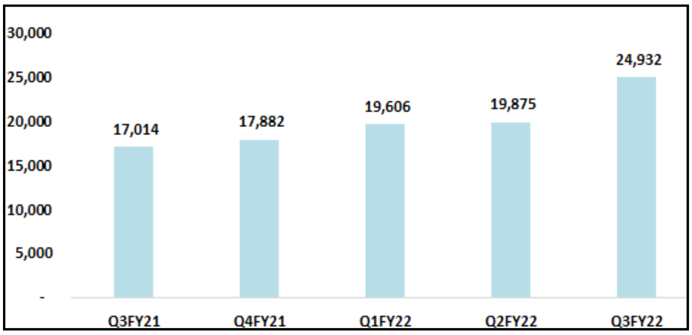
(f) Subsidiaries: The company has two subsidiaries M/s. Divi's Laboratories (USA) Inc., in the US (a profit share of 1.15% as on March 2021) and M/s. Divi's Laboratories Europe AG in Switzerland (a profit share of 0.34% as on March 2021) for marketing its nutraceuticals products and to provide a greater reach to customers within these regions.

**Exhibit 13: Annual Revenue Trend (Rs mn)**




*Source: Annual Reports, Progressive Research*

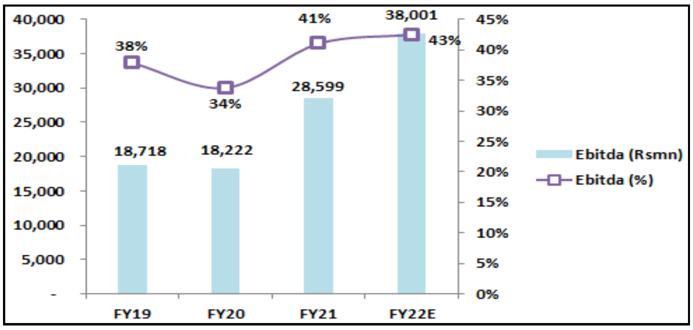
**Exhibit 14: Quarterly Revenue Trend (Rs mn)**




*Source: Annual Reports, Progressive Research*

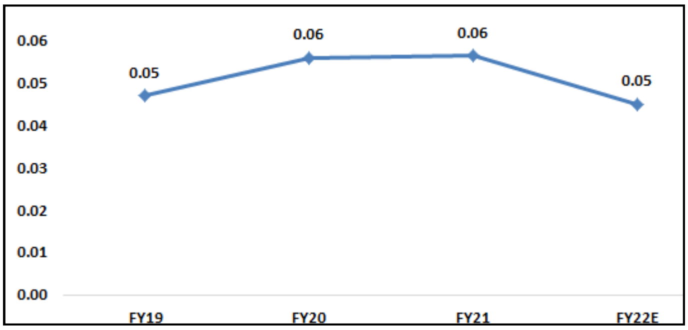
## Financials (contd.):

**Exhibit 15: Ebitda (Rs mn) v/s Ebitda Margins (%)**




*Source: Annual Reports, Progressive Research*

**Exhibit 16: D/E Trend**

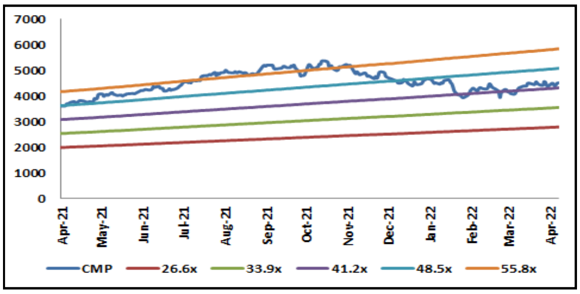



*Source: Annual Reports, Progressive Research*

**Risk and Concerns:** (i) Forex fluctuations: Divi's has significant exposure to the exports market (~87%); this could have an impact due to global economy or changing dynamics in the supply-chain of its products in the global markets besides any protective actions by governments of recipient countries. (ii) Pricing risk: Due to outbreak of Covid-19, normal business operations have been disrupted, resulting in significant price hike for API in past few months. The company is exposed to price risk and any correction in API prices could hurt the revenue and margins. (iii) Regulatory risk: Constant inspections, audits may pose a challenge to the entire approval process, new launches. Any non-compliance may result in regulatory ban on the products/facilities which may impact the future performance and approvals from the USFDA. Divi's has history of one import alert in FY18; however, it was able to resolve the same in few months as compared to several years in case of most other companies. (iv) Product concentration risk: With top 5 products contributing almost 49% of the total sales poses a risk which can have an impact on the overall volumes and revenues.

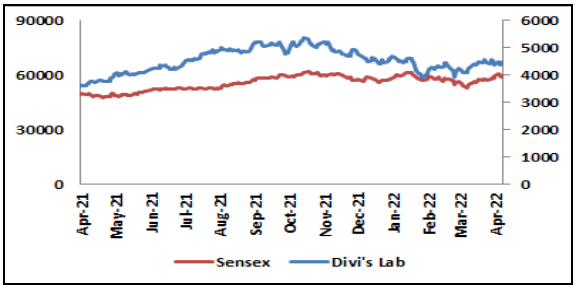
**Outlook and Recommendations:** Divi's has a well-established track record in offering quality products, catering to the API space along with nutraceuticals and custom synthesis business. The company is regarded as a reliable supplier of generic APIs to big pharma innovators. With a focused approach, Divi's has its roadmap set to venture into sartans, building capacities in a few more niche APIs as per the evolving demand scenario in the backdrop of 'China plus one' opportunities and upcoming opportunity size of ~USD20bn in molecules going off-patent over FY23-25E, increase the market share of the existing generics, immense opportunity lying ahead in the contrast media space with good orders under radar with the innovators. Europe and the US are the key geographies for the company having a share of 46% and 24% respectively for FY21. Currently, operating at a capacity of 80-85%, the company is in a position to accommodate additional requirements for any APIs that may arise. Being the authorized API manufacturer for Molnupiravir; the company is in a sizeable position to capitalise on any upcoming opportunities related to any new variants that may emerge. On further lucrativeness from Molnupiravir; there is some level of uncertainty as it would depend on MSD's ability to procure supply orders as the better perceived Paxlovid (from Pfizer) is available in the market. This would lead to concerns like sales moderations from the highs, but Divi's would sustain its mid-teens revenues growth over the longer term on the defined drivers for the base business. The generic API sales have largely stabilised and we expect mid-teens revenue growth in FY23/24E. Custom synthesis revenues were up 76% y-o-y in 9MFY22 on Molnupiravir benefits; but going forward we have factored moderation in sales from the same. As far as the Kakinada project is concerned; after the ownership transfer from the APIIC, the company would be in a position to commence the construction work. Successful completion of backward integration, better operational efficiency, strong net cash position with consistent cash generation, almost debt free status, strong outlook both in CS and generics based on significantly high visibility capex and customer stickiness, places Divi's in a better position holistically. Any impact of current macro issues (e.g. higher raw material and logistics costs) and imminent decline in Molnupiravir sales should subside over the next few quarters. We recommend Buy on the stock based on Divi's visibility on long-term growth drivers across segments and consistent delivery on cost efficiencies for a target of Rs5206 over 12 months horizon.

**Exhibit 17: One year forward P/E**




*Source: Ace Equity, Progressive Research*

**Exhibit 18: Price v/s Sensex**




*Source: Ace Equity, Progressive Research*

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