Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for those 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result…- Charlie Munger

It is rare to find a company that has grown its free cash flows from ~Rs 191 crores in 2009 to ~Rs 1200 crores in 2022 while maintaining avg. post-tax RoCE at 24%, EBITDA Margins at 40% while being completely debt free. Company's performance over the past several years can be referred from *Exhibit no. 1*.

Exhibit no. 1

*** in INR Crores**										
Particular	***2014***	***2015***	***2016***	***2017***	***2018***	***2019***	***2020***	***2021***	***2022***	***CAGR (8 Yrs.)***
PBT	991	1072	1393	1395	1231	1855	1819	2666	3684	18%
EBITDA (1-Tax)	868	990	1249	1187	1022	1526	1570	2242	3274	18%
Total Income	2566	3158	3837	4139	3977	5071	5502	7032	9035	17%
PAT	773	852	1126	1060	877	1353	1377	1984	2960	18%
CFO	557	826	1038	1150	776	954	1216	1947	1912	17%
Net Capex	246	307	396	377	274	733	1183	910	713	14%
EBIT (1-Tax)	776	854	1131	1064	879	1357	1384	1986	2962	18%
Net Fixed Assets	1366	1527	1703	2003	2116	2580	3702	4414	4795	17%
WC (Ex Cash)	1588	1932	2434	3272	3769	3688	3630	2906	4337	13%
Total Debt	18	27	42	36	63	106	34	0	0	
Shareholder's Funds	2963	3495	4293	5357	5925	6957	7310	9295	11728	19%
FCF	310	519	642	774	502	221	33	1037	1199	18%
Debt / Equity	0.01	0.01	0.01	0.01	0.01	0.02	0.00	0.00	0.00	0.01
EBITDA Margins	43%	39%	40%	37%	35%	41%	37%	42%	45%	40%
Gross Margins	64%	61%	60%	62%	61%	63%	61%	67%	67%	63%
Net Profit Margins	31%	27%	30%	26%	23%	27%	26%	28%	33%	28%
Post Tax RoIC	26%	25%	27%	20%	15%	22%	19%	27%	32%	24%
Post Tax RoCE	26%	24%	26%	20%	15%	19%	19%	21%	25%	22%
# Avg. of 9 years has been taken for all ratios										

Divi's Laboratories was founded in 1990 & the company is engaged in manufacturing generic compounds, nutraceutical ingredients and custom synthesis of APIs & intermediates for global innovator companies. The company is highly selective in its generic product portfolio as it has only 32 APIs that it manufacturers with it being Top 2 API manufacturers in the world for 18 out of 32 molecules. Divi's has achieved this leadership position because of various factors such as backward integration to basic starting materials, dedicated production blocks with large batch sizes & significant capacity creation ahead of time.

Why we remain positive about Divi's prospectives –

Divi's is the only generic API company in India that does not make formulations and hence does not compete with their customers. APIs are the main salt of a drug which are then used to make formulations. Other generic manufacturers who have in past ventured into manufacturing APIs ended up making formulations as well, and this way they started competing with their customers. Thus, Divis is able to command a price premium for not being in formulations and playing a complementary role, and not competing.

The company enjoys long gestation periods & large regulatory hurdles which acts as an entry barrier in this industry. Creating manufacturing capabilities is not enough, one must hire skilled personnel, take approvals from different regulatory bodies like USFDA, validate the sites by the pharma innovators: all of which requires quite long periods of time & resources.

Respect for Intellectual Properties is the most valuable qualitative aspect in custom synthesis. 12 out of the top 20 big pharma companies across US, EU and Japan are associated with Divi's for more than 10 years showcasing values & integrity of the entrepreneur running the business.

Divi's track record provides comfort on execution capabilities of the management. The company was 20th to enter some of the APIs such as Naproxen, Gabapentin, Dextromethorphan. As of today, it has attained market leadership with more than 60-70% market share in these APIs. Furthermore, Divis is backward integrated & produces their own starting materials for manufacturing of these APIs therefore eliminating any dependency on Key Starting Materials.

Contrast Media APIs today are anywhere between 5-6 Bn USD and are growing at double digits. There are 2 types of contrast media APIs namely Iodinated Contrast Media (ICM) & Gadolinium Contrast Media (GCM) of which Iodinated Contrast Media is the most widely used & accounts for the largest share of the market. Majority cost to produce ICM is Iodine & this is where Divi's has created serious competitive advantage over its competitors such that it can recover & recycle all iodine that goes into waste streams. It can add tremendous efficiency & can help Divis attain cost leadership as Iodine which was ~Rs 2200 per kg during 2015 is now ~Rs 6500 per kg.

$20 Bn drugs are going off patent between 2023 – 2025 & Divis has already selected the drugs they wish to enter & has developed technologies which is currently under validations by regulatory authorities. Once validated, these should add another stream to the Generic APIs division.

The biggest complication manufacturing Sartans is creation of Azido & Nitrosamine impurities along with it. Sartans are class of drugs that are used to treat high blood pressures. Divis has developed technologies via which these impurities are not created while manufacturing Sartans & this has led to enabling Divis manufacture pure Sartans that are preferred by their clients. USFDA & EDQM have audited their Sartans facility & concluded with no observations. Furthermore, they have started manufacturing Ortho Tolyl Benzonitrile in house (which is the starting material for Sartans) thus adding to their competitive strength.

During COVID – 19, Divis had demonstrated its ability to deliver Molnupiravir to Merck in record time that we believe is likely to open up many opportunities going forward because there aren't many players who can handle such large volumes in record time. Now, we believe if the big pharma innovators need a partner for NCE (New Chemical Entity) to commercial scale within 6 months meeting large volumes of demand, there aren't many custom synthesis players to go to & Divis should be one of their shortlisted suppliers.

Risks to our thesis –

Regulatory risk is perhaps the largest risk faced by all Pharma companies wherein one adverse observation by regulators could impact a lot on the revenues that the firm can generate. Divis was also served one adverse observation by USFDA in September 2017 in their Unit II.

During FY22, Divis was commercially supplying a 75% gross margin molecule named Molnupiravir which was a covid drug. Due to this, FY22 numbers contained one off event which created a large base & therefore performance in FY23 was not impressive compared to large base of FY22.

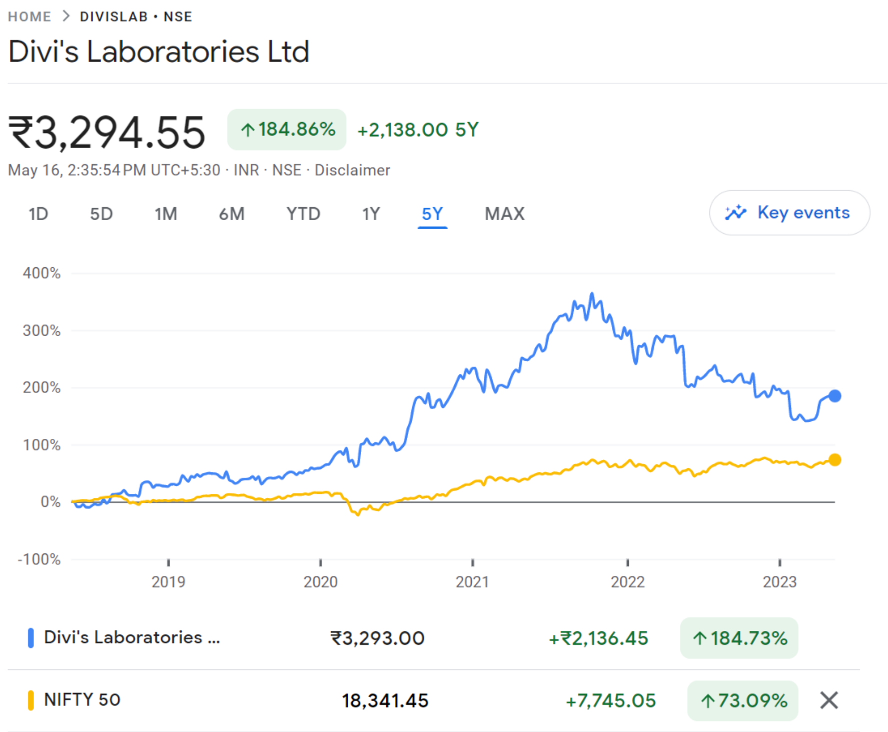
Divis has mainly 2 divisions – Generic APIs & Custom Synthesis of APIs & Intermediates. Whilst generic API division is more consistent, its custom synthesis division is quite lumpy & at times there could be material differences in their revenues and profitability when compared to previous year.

Its current CFO – Mr. Kishore Babu was fined by SEBI for indulging in insider trading.

Off late, there has been pricing pressure in generic APIs.

Market Performance in the past 5 years (Exhibit no. 2)

Exhibit no. 2



The past 1 year has not been rewarding for Investors of Divis Laboratories because of certain factors that have resulted in degrowth of both revenues & profits compared to FY22 numbers. Last year, Divis had a custom synthesis contract of supplying a covid molecule that was a 75% gross margins product for Divis due to which FY22 numbers were extraordinarily impressive due to one off revenues & profits. Inherently as covid came to an end, so did the contract which resulted in sharp fall in both revenues & profits: as a result, the stock of Divi's has not done well if one were to look at the past 1 year.

Time horizons in equity investing plays a major role in creation of significant wealth. We have not come across any business that have delivered every quarter in a year. It is wise to understand that every business goes through some lumpiness in their operations. What's important is how strong is the execution capabilities of the management? Is the business operating in a niche market & has competitive strength? How are the governance standards of the company?

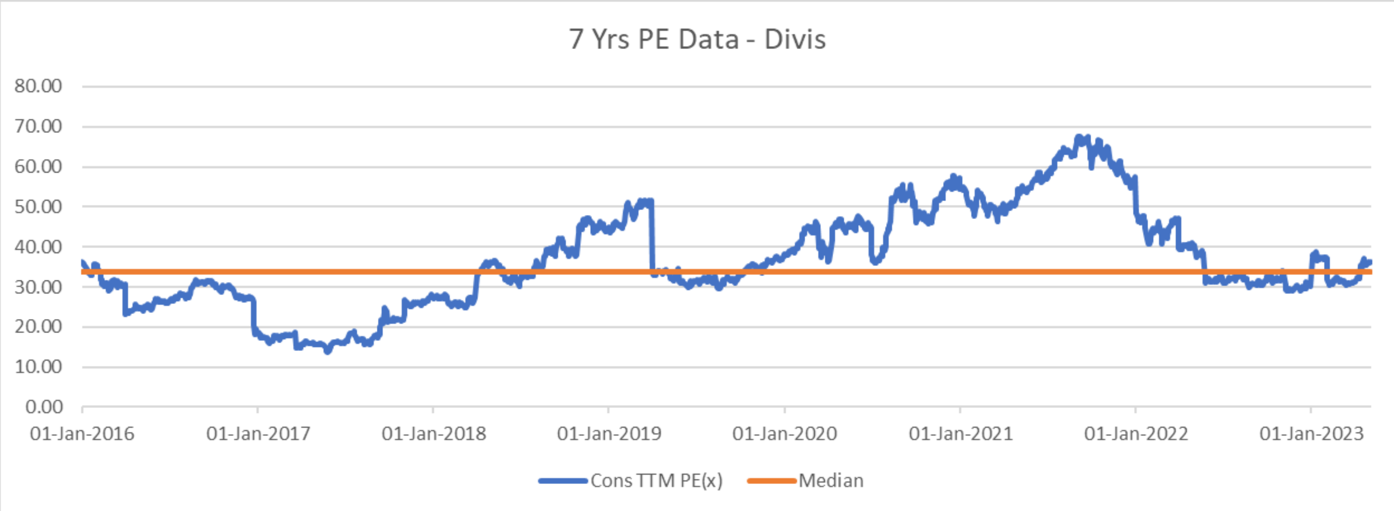
Although the past 1-year performance has been abysmal, however if one were to look at the 5-year performance of the company w.r.t NIFTY *(Exhibit no. 2)*, Divis Labs has done reasonably well because in the long run a company will always earn returns that the underlying business earns, and in Divis Labs the underlying business performance is very impressive over long term. *(Refer Exhibit no. 1)*

Valuations

We intend to be permanent owners of great businesses as long as our investment thesis is intact & there are no major governance issues within the company. Entry valuations do matter in investing & getting entry valuations correct results in decent 18-20% compounding in longer time frames. As often claimed, valuation is an art rather than science because there are multiple factors that could determine why a company could be at discount to their fair value even at high PE multiples and sometimes a company trading at single digit PE multiples could be expensive.

We at Delta Investments tend to invest in high quality companies which have the following traits – High RoCEs, prudent capital allocation by the management, no corporate governance issues, high cash conversions, himalayan barriers to entry, large headroom to grow.

Exhibit no. 3



Divis labs is currently trading at ~35x TTM PE (refer Exhibit no. 3). We believe Divis falls under our definition of great business showcasing superior return ratios, credible management, consistent gross margins. Moreover, looking at the past 7 years of PE data, it is currently trading at its median PE levels.

We are not an advocate of buy at any price (BAAP) strategy. However, we believe a high-quality business shouldn't be sold if valuations are the only problem. We endeavour to get entry prices at fair value & believe Divi's is currently available at a decent fair price which underappreciates the greatness of the underlying fundamentals. As a result, we do see value in Divi's Labs in current market capitalization & would recommend following a tranche-based investing approach. *(Investing style wherein investing in a stock is done in tranches to benefit from declines in share prices)*

Disclaimers -

Analyst covering this company has financial interest in the company & therefore views can be biased.