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Sector Update

Rubber Gloves

OVERWEIGHT ↔

Forging Ahead, Pandemic or no

The H5N1 outbreak in Hong Kong has dominated headlines since the Chinese government raised the alert level to serious. Should the virus continue to spread, it will be positive for the rubber glove sector, just like in 2009 when the H1N1 virus was declared a pandemic. That said, we think the worst is over for the sector in terms of operation as well as earnings performance. We believe the sector theme for FY12 would be natural rubber, especially given the pullback in natural rubber latex prices. Maintain Overweight, with Supermax as our top sector pick.

H5N1 a new healthcare threat? Although still far from reaching pandemic proportions, we note that the Chinese government has raised the alert level on the H4N1 virus to "serious" from "alert" recently. Last Saturday, it was reported that a man from Shenzhen who contracted the virus died in hospital on multiple organ failure. Nonetheless, we understand that the World Health Organization (WHO) will only declare the virus to be a pandemic if it is widespread, infectious and kills many people.

Positive impact for sector if a pandemic declared. During the 2009 H1N1 pandemic, all the share prices of rubber glove stocks rallied due to their consistent quarters of earnings improvement. Today, demand for examination gloves is at levels similar to those in 2009/2010 and so is the cost of producing rubber gloves. What is looking even better now for glove companies compared to 2009/2010 is that competition has lessened, which augurs well for the sector's earnings and enhances its visibility. On the flip side, there is also a slight oversupply of gloves, minimal healthcare reforms and valuations are now more expensive than previously.

But the worst is over, pandemic or no. This is on the basis that: i) latex price, which makes up 60%-70% of glove makers' total cost, has retraced to RM6.50/kg from a high of RM11.00/kg; ii) many customers have gotten used to thinner gloves, which involve lower production cost; iii) the USD has strengthened against MYR; iv) the new production lines have dual capability and are better able to cater to customer demand, and v) there are fewer players to share a bigger market.

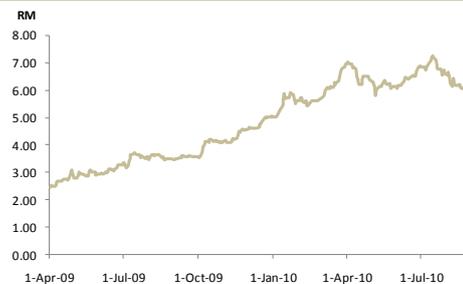
Maintain Overweight. Our top pick is **Supermax**. Also, we think the focus for FY12 will shift to natural rubber, which should benefit players like Supermax and Top Glove. However, we maintain Neutral on Top Glove given the stock's rich valuation. We see Supermax offering the same exposure to natural rubber gloves as Top Glove and yet is far more appealing from a valuation angle. Also, Supermax's earnings are more sustainable as the company derives secondary income from its distribution business.

Stock	Price RM	Target RM	Mkt Cap RMm	Volume '000	PER (x)		FY0 ROE %	FY1 DY %	Rel. Performance %			P/NTA (x)	Rating
					FY1	FY2			1-mth	3-mth	12mth		
Adventa	1.60	2.00	244.8	772.1	9.6	7.4	1.9	5.0	-2.9	-1.1	-32.3	1.2	Buy
Hartalega	5.87	7.40	2133.7	373.0	10.3	9.4	38.5	4.3	2.3	0.1	10.2	3.7	Buy
Kossan	3.30	5.00	1055.0	495.5	11.0	8.6	26.4	3.0	1.7	11.7	4.7	1.3	Buy
Supermax	3.96	5.50	1313.1	1382.4	12.3	9.4	23.8	2.9	8.1	30.9	-2.2	2.1	Buy
Top Glove	5.12	4.52	3183.6	1399.3	21.8	19.3	10.1	3.1	8.5	19.4	1.5	1.5	Neutral

WHAT IF A PANDEMIC OCCURS?

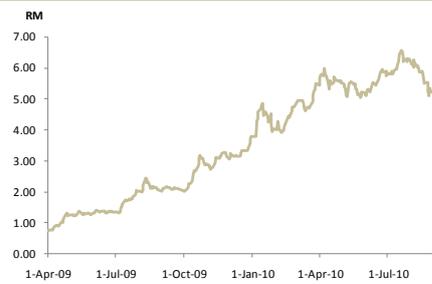
H1N1 pandemic from 2009-2010. The H1N1 outbreak began in April 2009. By June that year, the World Health Organization (WHO) and US Center for Disease Control and Prevention (CDC) had declared the outbreak a pandemic. The pandemic began to taper off after a few months, and by May 2010, the number of cases had declined sharply. Subsequently, in August 2010, WHO Director-General Margaret Chan declared that the H1N1 pandemic had run its course. The organisation's statistics as at July 2010 showed that the H1N1 virus had killed more than 18k people since it surfaced in April 2009, with researchers estimating that the virus' global infection rate was between 11%-21%. The extent of the virus' spread and the high casualty rate of those infected provided the fuel with which rubber glove stocks rallied (see Figures 1 to 5 below) since extreme precaution had to be taken at all healthcare centers in handling the stricken.

Figure 1: Top Glove's share price



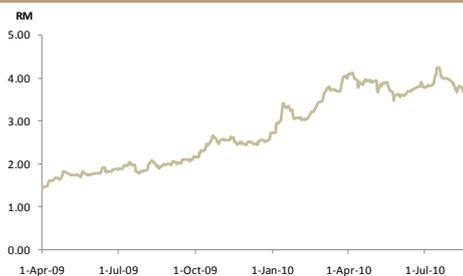
Source : OSK, Bloomberg

Figure 2: Supermax's share price



Source : OSK, Bloomberg

Figure 3: Kossan's share price



Source : OSK, Bloomberg

Figure 4: Hartalega's share price



Source : OSK, Bloomberg

Figure 5: Adventa's share price

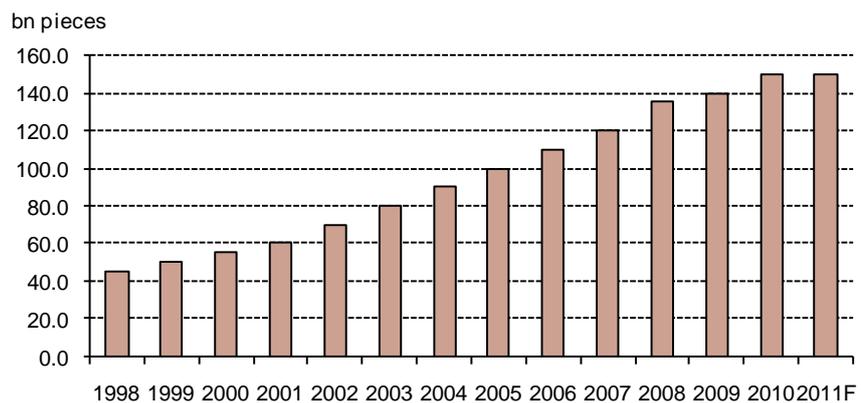


Source: OSK, Bloomberg

How the situation today differs from 2009. This entails analysis from a few different perspectives:

Incremental demand for examination gloves - Similar. We believe that the demand during both periods (now and back in 2009) are quite similar. In 2009, the demand was quite strong because the global crisis in 2H08 also saw crude oil price collapsing from USD147/barrel to USD30/barrel by end-2008, leading to minimal stocking up of examination gloves among healthcare MNCs and their customers as expectations were for glove prices to drop further. Looking at the demand situation today, we see some similarities in terms of the stock inventory of the healthcare MNCs, which we believe would also be holding minimal stocks, especially having witnessed a steep drop in natural rubber latex price from a high of about RM11.00/kg in April 2011 to about RM6.50/kg currently – all in a matter of 9 months. As before, most purchasers are anticipating a further drop in latex price as the automotive sector continues to languish, which will in turn dampen the demand for tyres, which utilize 70% of the world's natural rubber.

Figure 6: Global demand for examination rubber gloves



Source: OSK, various companies

Supply of examination gloves – Higher now. We believe the healthcare industry is still absorbing the additional supply from the capacity expansion initiated by most rubber glove manufacturers after the H1N1 pandemic was declared in 2009. Hence, we believe that rubber glove supply is now aplenty versus in 2009 when the sector itself was quiet. However, the good news is that the increment in new capacity has been on a decline as much of the new capacity arising from earlier expansion initiatives has been mostly taken up by healthcare MNCs. Also, demand can easily outstrip supply in the event a H5N1 pandemic is declared because we understand that the healthcare MNCs could potentially triple their stocks, especially on the understanding that rubber glove manufacturers may significantly hike their selling prices when it's a seller's market.

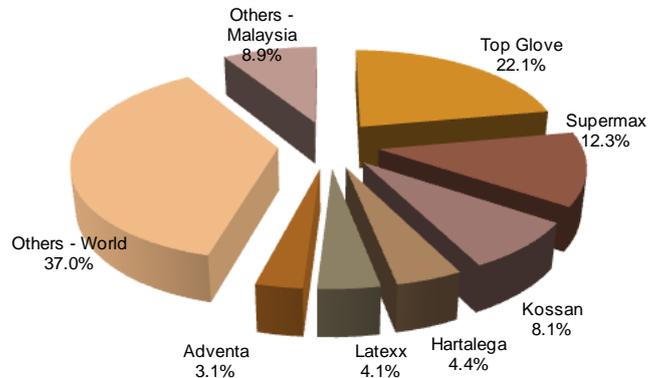
Figure 7: Summary of new capacity expansion by the rubber glove manufacturers

Company	Existing (Bn pc)	New (Bn pc)	Total (Bn pc)	Timeline
Top Glove	35	6	41	2012
Supermax	17	7	24	2012
Kossan	10	2	12	2012
Hartalega	9	1	10	2012
Adventa	4	2	6	2012
Total	77	20	97	

Source: OSK, various companies

Industry dynamics – Things are better now. This is because the number of competitors has declined slightly following the industry’s consolidation. Some players have voluntarily cashed out of the business while others may have been left with no option as production costs escalated in tandem with spiraling latex price from 2010-1H2011, resulting in significant margin erosion, especially given that they are not big in size. Hence, with fewer competitors, the bigger rubber glove manufacturers would wield greater oligopolistic power to capture supernormal profits in the event of another pandemic.

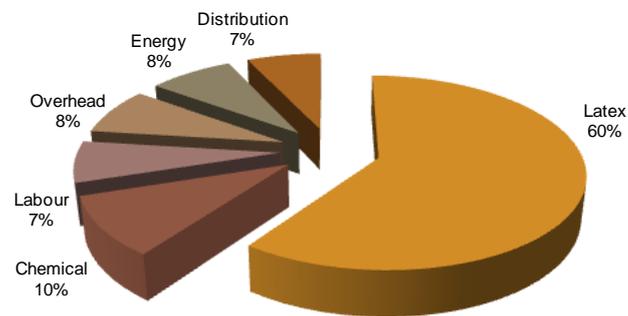
Figure 8: Market share of rubber glove manufacturers



Source: OSK, MREPC

Production cost – Issue mainly with latex price. Latex cost is the main production component, making up about 60% of rubber glove manufacturers’ total production cost. The price of the commodity at RM6.50/kg currently is still much higher than the RM4.00/kg it fetched in 2009. However, despite this vast difference in terms of pricing, one should note that the prices during both periods were at a lows point in their respective cycles. Hence, this should be positive for rubber glove manufacturers’ margins.

Figure 9: Average production cost of rubber glove manufacturers



Source: OSK, various companies

Earnings of rubber glove manufacturers – On the mend. In this respect, it may not be fair to compare rubber glove makers’ earnings in 2009 with today’s numbers since their production capacity is bigger now. Also, with technological improvements, they are now able to produce thinner gloves at a slightly faster pace, which should give rise to a positive margin impact. Overall, we believe the darkest days of poor earnings performance for the industry are over as latex price started retreating from April 2011 onwards.

Extent of healthcare reform – Minimal to date. From 2009-2010, there was healthcare reform in the US, which also led to healthcare reforms in other parts of the world. Although there have not been many reforms to date from 2011 onwards, we understand that healthcare awareness is growing in importance in China, where numerous small but fragmented Chinese rubber glove manufacturers are beginning to produce basic examination nitrile gloves. We also gather that these are mostly for domestic use since these gloves have yet to catch the attention of global healthcare MNCs in terms of quality and suitability for examination purposes in developed countries like the US and Europe, which are still largely dominated by Top Glove, Supermax, Kossan, Hartalega and Adventa.

Sector's attraction – It's more visible now. The rubber glove sector has always been regarded as a defensive sector since it falls under the healthcare category and as the demand for its products and services are resilient against global economic crises. However, what is now different from 2009 is that this sector has gained visibility among investors after its run-up in 2010. Today, investors recognize the importance of the sector's contribution to society and better hygiene practices.

Glove stocks' appeal – Becoming more expensive. The valuations of almost all the rubber glove stocks have doubled compared to their pre-2009 levels. We deem this fair because: i) their production capacity has expanded by at least 20%-30%; ii) they entail a longer learning curve, which gradually leads to more efficient production, iii) they are more technologically advanced now, which helps in enhancing their margins, and iv) there are now fewer manufacturers sharing a growing pie. In addition, from the trading angle, there is now better liquidity, visibility in investors' radar, and better access to glove companies' managements.

What's in Store For Rubber Glove Manufacturers?

Worst is over, even in the absence of a pandemic. We are of the view that the worst is over for the industry based on the analysis below:

Latex price has retraced meaningfully to RM6.50/kg from an all-time high of RM11.00/kg. Of course, the main reasons for this drop include: i) the slowdown in the automotive sector as tires use up about 70% of global natural rubber; ii) there is now less speculation on commodities, including latex, as uncertainties cast a cloud over the global economy, especially in Europe; iii) the recent floods in Thailand did not affect the country's rubber plantations, which were mostly located in the southern region, and iv) new rubber plantations are coming up in Vietnam as well as Cambodia, which will translate into more latex supply in the upcoming months.

Figure 10: Latex price on a downtrend



Source: OSK, Bloomberg

Latex price still above psychological floor price of about RM5.60/kg. Although there is no floor price for natural rubber latex, that for hard rubber is USD3.00/kg. Using this as comparison, the floor price for latex should technically be about RM5.60/kg (USD3.00/kg x 3.1 x 60%). Note that the USD/MYR conversion rate used here is 3.1, and latex is made up of 60% rubber and 40% water. Hence, at the current price of about RM6.50/kg, we still see room for latex price to fall further, especially when the commodity is not supported by strong demand, or is facing an over-supply.

Customers now used to thinner gloves, leading to lower production cost. This is a new development that arose out of necessity when natural rubber latex price spiked up to an unrealistic RM11.00/kg, resulting in the selling price of natural rubber gloves overtaking that of the traditionally higher-priced nitrile gloves. The lofty latex price led to some healthcare MNCs lowering their quality requirements on gloves, which consequently led to lower selling prices. Also, we understand from the industry that the US Food and Drug Administration (FDA) requirements were also lowered to accommodate the unreasonably high latex price. As the production cost/piece of glove has come down, glove makers are likely to see better margins going forward.

Stronger USD-MYR augurs well for exporters. On average, more than 90% of the examination rubber gloves produced are exported to developed regions like the US and Europe, making up 60%-70% of glove manufacturers' total sales. And as most of their transactions are denominated in USD, the strengthening of the greenback spells good news for glove players.

Figure 11: USD gradually strengthens against MYR



Source: OSK, Bloomberg

Dual production lines equal production flexibility. Among the rubber glove producers, there is a production theme every year, as Figure 12 below shows. To address the shift in preference, most of the new production lines installed by rubber glove manufacturers today have dual production capability. This allows them to produce nitrile and natural rubber gloves interchangeably, depending on customers' demand.

Fewer players, more market share. Large rubber glove manufacturers like Top Glove and Supermax are growing at the expense of the smaller manufacturers which have minimal competitive advantage, especially in terms of pricing since their gloves are not as attractively priced as Top Glove and Supermax, which can trim their cost/piece through economies of scale. Hence, over time, the industry will naturally consolidate and become smaller as the stronger companies survive while the weaker ones are sold off to the bigger companies. That said, the examination glove market would still grow even without a pandemic as the increasing awareness of hygiene among the world's population is sufficient to drive global growth by about 1%-3% p.a, while penetration into a new market would be a bonus to expansion of the overall market.

Maintain Overweight on Sector

Maintain Overweight. We remain positive on the sector for FY12 even without a healthcare pandemic because we believe the worst is over in terms of both their operational and earnings performance as elaborated earlier. Also, we continue to see most rubber glove stocks as defensive stocks now since their share prices have retraced quite significantly from their highs towards the end of the H1N1 pandemic days in 1H10.

Natural rubber glove back as theme play. For FY12, we believe the theme for the rubber glove sector is natural rubber. This is because: i) natural rubber latex price has fallen significantly from its high, resulting in the natural rubber glove being priced back lower than the nitrile glove, ii) nitrile latex instead is on a rising trend following the high oil price as well as strong demand coming from China nitrile glove manufacturers, and iii) there is strong competition on the nitrile glove segment from China, resulting in a high possibility of a price war and hence leading to margin erosion of the nitrile glove manufacturers.

Figure 12: Yearly theme play for examination rubber gloves

Year	Event
2008	Peak NBR glove demand – Better quality glove
2009	Peak NR glove demand – Developing countries
2010	NBR – Cheaper
2011	NBR – Cheaper
2012F	NR – Likely cheaper and likely oversupply NBR

Source: OSK

Top pick remains Supermax. The predominantly natural rubber glove players are Top Glove and Supermax, as their natural rubber glove product mixes comprise 70%-80% of their total production. However, we are still Neutral on Top Glove for its rich valuation and would thus recommend Supermax, which offers the same exposure to natural rubber gloves as Top Glove, and yet is more attractive valuation-wise. Other than that, we believe that Supermax's earnings are more sustainable since the company also derives a secondary income from its distribution business. Finally, other than these 2 companies, the other player with the next highest natural rubber glove exposure is Kossan, with a 40% natural rubber and 60% nitrile glove mix, and on which we also have a Buy.

APPENDIX

H5N1 versus H1N1. Based on secondary research, we found that the 'Influenza' A (H1N1) virus is a sub-type of the influenza A virus and was the most common cause of human influenza (flu) in 2009. Some strains of H1N1 are endemic in humans and cause a small fraction of all influenza-like illness and a small fraction of all seasonal influenza. H1N1 strains caused a few percent of all human flu infections in 2004–2005 while other strains are endemic in pigs (swine influenza) and in birds (avian influenza). H1N1 is often called swine flu too. On the other hand, the Influenza A virus sub-type H5N1, also known as "bird flu" or "avian flu", A(H5N1), or simply H5N1, is a sub-type of the influenza A virus which can cause illness in humans and many other animal species. A bird-adapted strain of H5N1, called HPAI A (H5N1) for "highly pathogenic avian influenza virus of type A of subtype H5N1", is the causative agent of H5N1 flu, commonly known as "avian influenza" or "bird flu". It is enzootic in many bird populations, especially in South-East Asia.

Recent H5N1-related events. From our secondary search based on press reports and the internet, we found that: i) before Christmas 2011, a dead bird found in the New Territories in Hong Kong was tested positive for the bird flu virus, just days after health authorities culled 17k live poultry in a wholesale market after a dead chicken there tested positive for H5N1. This is the first new case of bird flu since 2008. As a result of the earlier H5N1 case, the Chinese government raised the alert level on the virus to "serious" from "alert," and suspended live poultry imports for 3 weeks, and ii) recently, health officials at the southern Guangdong province said the Shenzhen man who contracted H5N1 died in hospital last Saturday from multiple organ failure. The authorities also added that about 120 people who had close contact with the man have not showed any signs of flu.

Will World Health Organization (WHO) declare a pandemic? We understand that there are a few stages to consider when a novel influenza virus moves from the first few infections in humans through to a pandemic. This starts with the virus mostly infecting animals, then with a few cases where animals infect people, then moving through the stage where the virus begins to spread directly between people, and ends with a pandemic when infections from the new virus have spread worldwide. A disease or condition is not a pandemic merely because it is widespread or kills many people; it must also be infectious.

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