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CIMB Research Report

QUICK TAKES

19 October 2009

MALAYSIA

Rubber Gloves

OUTPERFORM Maintained

Time for g(love)

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The Edge feature

Over the weekend, The Edge penned an article on the current global shortage of rubber gloves. Glove manufacturers are running at full capacity and some have hit record earnings. The overall conclusion of the piece was broadly in line with our positive view on the sector even though there were discrepancies in the information contained in the article and information that we had gathered from our industry contacts. We maintain our OUTPERFORM call on the sector and make no change to all our earnings forecasts in view of the favourable outlook for the industry. All the glove stocks in our coverage remain Outperforms, with Kossan and Supermax staying as our top picks. Potential re-rating catalysts include the continuing uptick in demand from the healthcare industry, ongoing capacity expansion and strong earnings growth.

Highlights from the article

Global shortage… The current global shortage of rubber gloves has led to record profits for Malaysian glove manufacturers. The recent quarterly results announced by Top Glove (TOPG MK, Outperform) and Supermax (SUCB MK, Outperform) showed record profits and margin expansion. Top Glove recorded a net profit margin of 13.3% in its 4Q (Jun-Aug quarter) while Supermax showed a net margin of 16.9% in its 3Q results (July-Sep quarter).

… due to tight supply. Last year's demand-supply balance turned into conditions of tight supply early this year. It has since deteriorated to a situation of shortage. The tight supply in the middle of the year was said to be due to a normal annual increase in demand that was not matched by an increase in output capacity while the current shortage is the result of the outbreak of the H1N1 flu. The shortage has led to a rationing of supply as manufacturers partially fulfil new orders because their existing capacities cannot meet demand.

No spare capacity available. While the shortage persists, industry players express disappointment that they do not have any spare capacity to utilise for an increase in revenue. They are accelerating capacity expansion plans.

Comments from the nitrile player. Hartalega (HART MK, Outperform) commented that it is working at full capacity. The construction of its fifth plant is on schedule and the first line should start rolling in Jan or Feb next year. The company said that the industry is happy with the profit margins it is getting, adding that the industry cannot raise margins much further without upsetting their customers.

Expansion not keeping up with demand. The article goes on to say that there will be demand pressure as there is annual demand for about 130bn pieces of gloves and that has typically increased at an annual rate of 8% or 10bn pieces. The industry needs to invest in manufacturing capacity for an additional 10bn pieces every year but the industry is only adding only about 8bn or 9bn pieces a year or less, says Hartalega. The demand for gloves has firmed up further due to H1N1, increasing demand by about 15% this year. The company expects demand to continue to expand, slowing to a normal rate of about 8% a year. But it would not contract or stop growing because many countries are still not using medical examination gloves.

Supermax is operating at the max. Supermax also provided some comments to The Edge. Its plants are operating at full capacity, with orders fully booked up to Dec. It is currently selling their capacity for Jan and Feb.

Backlog orders. Since H1N1 occurred, there has been a global shortage for rubber gloves. Customers now have to wait longer for their orders to be met. The usual 45 days delivery period has been extended by a few weeks. Due to this, Supermax said that instead of fulfilling each order as it comes, it now has to ration its supply, i.e. try to give some supply to all its customers. Supermax expects the industry conditions to remain favourable. However, untoward circumstances could happen, including a rapid fall of the US$ and a sudden, sharp rise in latex prices.

Sustainable margins. Nevertheless, margins can be stable in this industry. Supermax mentioned that glove prices can be adjusted to the previous month's average exchange rate and latex price through an adjustment mechanism known as PMA or previous monthly average. Thus, gradual changes, even if negative, can be adjusted through higher glove prices but with a time lag.

Comments

Broadly in line. Most of the views and information contained in the article were not a surprise but there were discrepancies in the information contained in the article and information that we had gathered from our industry contacts. Industry players told us that the demand for rubber gloves is about 140bn pieces while the article quoted only 130bn pieces.

Excess capacity was intentional. The article also mentioned that there was enough supply to meet demand last year. While we concur with this, we gathered that the big glove manufacturers were only operating at about 75% average utilisation then while the smaller ones were at full capacity given their niche in powder-free and nitrile gloves. During its recent briefing, Top Glove said that it has always maintained a utilisation rate of around 75% to ensure that it is always prepared for large orders in the event of disease outbreak or big orders from its major customers. This strategy is paying off as it started operating at 90% utilisation since the H1N1 outbreak. Supermax, on the other hand, operated at only about 75% utilisation last year but has been running at its limit of 86% since H1N1 flared as refurbishment works prevented it from operating at 100% utilisation in 2Q and 3Q. It expects to run at 90% utilisation in 4Q to cater to orders which are currently booked up to December.

Rationing of supply. On average, global glove demand has risen by about 8-10% per annum. Due to the strong demand coming in since the A(H1N1) outbreak, glove manufacturers believe that demand could go up by 15% this year and now have to find ways fulfil to their customers' orders. From our recent meeting with Supermax, we learnt that demand has been so strong that it has to give priority to the customers that it has strong relationships with as it currently does not have the capacity to handle all the orders. But the company is trying to satisfy all of its customers by giving some supply to them through the rationing of supply.

Major capex plans in place. In view of the favourable outlook for the industry, the glove manufacturers are going ahead with and, in some cases, bringing forward their expansion plans. For example, completion of Top Glove's Factory 20 has been brought forward from June 2010 to February 2010. Supermax plans to kick off its 12 new lines in its Meru plant by 1Q next year and intends to start putting in the lines and machineries next month. Latexx Partners (LTX MK, Outperform) might bring forward its capex from the middle of next year to Jan or Feb 2010. We gathered that most of this major capital expansion will use biomass facilities for heating as there is no guarantee of additional natural gas supply in the future.

Figure 1: Targeted annual glove production capacity (bn pieces)

	Current	2009	2010	Annual increase (%)	2011	Annual increase (%)	Growth in 3 years (%)
Hartalega	6.2	6.5	8.2	26%	10.5	28.0%	69.4%
Kossan Rubber	11.0	11.1	14.5	31%	19.0	31.0%	72.7%
Latexx Partners	5.2	6.0	7.6	27%	9.0	18.4%	73.1%
Supermax	14.5	14.5	17.4	20%	19.2	10.3%	32.4%
Top Glove	31.5	31.5	34.5	10%	34.5	0.0%	9.5%
Total	**68.4**	**69.6**	**82.2**	18%	**92.2**	12.2%	**34.8%**

Source: Companies, CIMB Research

Still lacking pricing power. Regarding margins, we think that the glove manufacturers still lack pricing power as they rely on the big customers such as Kimberly Clark, Ansell and Cardinal Health to purchase consistently from them. Buyers, especially the MNCs, generally have stronger buyer power as they own the brand names and control the distribution networks. We think that the glove manufactures are being too conservative with their margins in the fear of losing these major customers. Given that the five biggest manufacturers control half of the global supply, they should collaborate to raise prices and expand their margins.

OBM benefits most. We also think that glove manufacturers should also move towards establishing their own brands and controlling their own distribution networks. As highlighted in our 27 July sector report, overdependence on the OEM market may not be good for the glove makers in the long term. Malaysian Rubber Export Promotion Council (MREPC) encourages local glove manufacturers to develop their own brands while promoting Malaysia's own national brand, which is the Standard Malaysian Gloves (SMG). Within our coverage, the biggest OBM player is Supermax which derives 55% of its revenue from gloves sold under its own brand. Having their own brand allows OBM companies to command higher prices and expand margins, especially in situations where there is a shortfall of gloves due to high demand like the ongoing H1N1 flu.

Figure 2: Revenue mix between OEM and OBM

	OEM	OBM
Hartalega	96%	4%
Kossan Rubber	95%	5%
Latexx Partners	100%	-
Supermax	45%	55%
Top Glove	80%	20%

Source: Companies, CIMB Research

Valuation and recommendation

Demand to remain strong. For the past decade, global rubber glove demand has racked up consistent growth of about 8-10% per annum. The outbreak of diseases such as AIDS, bird flu, SARS, and more recently, H1N1 has resulted in more hygiene awareness and increasing healthcare spending by governments all over the world. We gather from the rubber glove manufacturers that this trend will continue and demand from H1N1 will spill over to 2010.

Maintain OVERWEIGHT. We maintain our OVERWEIGHT stance on the rubber glove sector and retain our earnings forecasts for all the glove companies under our coverage in view of the potential increase in demand and earnings for the glovemakers. Considering the strong quarterly results reported by Top Glove and Supermax, we think that there is a high chance for other rubber glove companies to report strong earnings as well. All the glove stocks in our coverage remain Outperforms. Potential re-rating catalysts include the continuing uptick in demand from the healthcare industry, ongoing capacity expansion and strong earnings growth. Kossan (KRI MK, Outperform) and Supermax remain our top picks. We like Kossan for its improving earnings ability due to its changing product mix and aggressive capacity expansion. Potential share price triggers for Supermax include higher contribution from its OBM gloves and distribution as well as upcoming capacity expansion plans.

Figure 3: Sector comparisons

	Bloomberg ticker	Recom.	Price (Local)	Target price (Local)	Mkt cap (US$ m)	Core P/E (x) CY2009	Core P/E (x) CY2010	3-yr EPS CAGR (%)	P/BV (x) CY2009	ROE (%) CY2009	Div yield (%) CY2009
Hartalega	HART MK	O	5.63	7.32	405	13.5	10.4	32.0	4.3	36.9	2.1
Kossan	KRI MK	O	4.86	7.73	230	8.4	7.5	23.2	2.1	18.9	2.1
Latexx	LTX MK	O	2.40	2.56	139	9.6	7.0	75.9	2.8	33.9	0.8
Supermax	SUCB MK	O	3.30	6.31	260	6.9	6.4	36.8	1.6	26.7	2.7
Top Glove	TOPG MK	O	8.40	10.55	759	14.6	13.2	10.8	2.9	21.7	2.5
Simple average						**10.6**	**8.9**	**35.7**	**2.7**	**27.6**	**2.0**

O = Outperform, N = Neutral, U = Underperform, TB = Trading Buy and TS = Trading Sell
Source: CIMB Research, Bloomberg

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