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Sector Update

Rubber Glove

OVERWEIGHT ↔

Robust Demand Spills Over to 2010

2009 was a very good year for the rubber glove manufacturers, thanks to strong global demand spurred by the global economic recovery, increased health awareness after the H1N1 pandemic and having a new target market in the developing countries. Going into 2010, the industry is expected to see robust demand for medical rubber gloves due to scarce supply as a result of the minimal capacity expansion undertaken in 2009. We maintain Overweight on the sector as well as our top picks Top Glove, Supermax and Kossan.

Global demand to grow about 10bn pieces a year. According to rubber glove manufacturers, global demand for 2010 is estimated at a minimum 150bn pieces p.a. on growing hygiene awareness following the H1N1 pandemic. Also, we believe demand is still outpacing supply given the minimal capacity expansion in 2009 of about 5bn pieces p.a. versus the annual demand growth of 10bn pieces. Finally, there are also constraints to new capacity expansion since no new natural gas is being made available for the industry in Malaysia and the alternative in using biomass to generate power entails taking 12-15 months to get a biomass boiler ready for use. Consequently, we estimate a scarcity of glove supply in 1H2010 before new capacity starts to kick in later in 2H10.

Developing countries the growth markets. This new target market emerged on growing hygiene awareness. Brazil is a good example, whereby demand surged after the Brazilian government tightened regulations on rubber gloves entering the country. The exceptionally strong demand from this country has mainly benefited Top Glove and Supermax, which we understand command market shares of about 40% and 30% respectively of the entire Brazilian market. Going forward, we believe the developing countries would be the growth market for rubber gloves makers, who would now be setting their focus back to basic natural rubber gloves as part of their expansion.

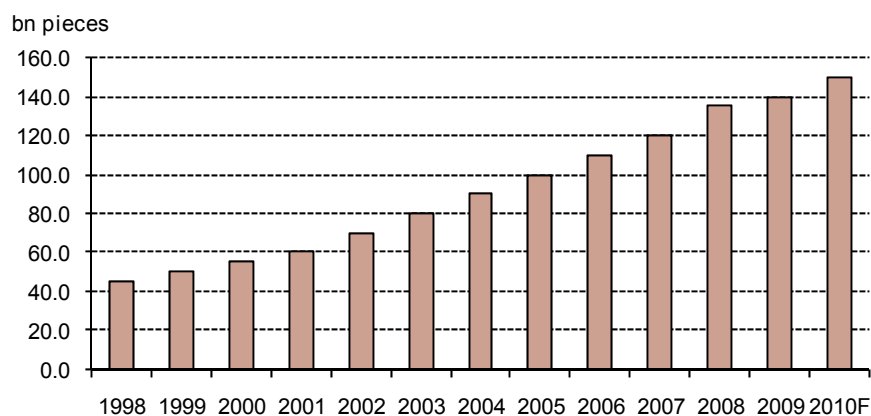
Maintain Overweight. We are raising the PER valuation for the entire rubber glove sector from an average PER of 12x to 15x premised on: 1) continuous strong demand for rubber gloves from both the medical and hygiene markets; 2) increased health and cleanliness awareness after the H1N1 pandemic; 3) a high possibility of governments of developing countries implementing compulsory usage of glove, especially for the medical market; 4) a recovery in the global economy, which would ultimately lead to an increase in living standards across the globe, and 5) local rubber glove manufacturers embarking on further capacity expansion to boost revenue and profits. We believe an upward re-rating of the sector PER valuation is timely in view of the prevailing market sentiment and robust global strong demand for medical rubber glove. Traditionally, Top Glove traded at a PER of as high as more than 25x and we believe allocating a minimum increase in 2x PER valuation to 17x would be appropriate. Its peers are still trading below their historical high at current share prices. Our top picks remain **Top Glove, Supermax and Kossan.**

Stock	Price RM	Target RM	Mkt Cap RMm	Volume '000	PER (x) FY1	FY2	FY0 ROE%	FY1 DY%	1-mth	3-mth	12mth	Rel. Performance %	P/NTA (x)	Rating
Adventa	4.05	5.37	581.2	2311.0	34.2	15.7	10.9	1.5	64.5	112.3	270.9	2.9	2.9	Buy
Hartalega	7.07	8.12	1713.1	346.4	15.8	12.7	45.0	1.1	18.6	23.1	177.5	7.3	7.3	Buy
Kossan	6.46	9.52	1032.7	369.6	16.5	9.5	19.8	1.9	27.7	32.5	44.2	2.9	2.9	Buy
Supermax	5.81	7.94	1541.2	4346.0	13.2	11.0	10.8	0.7	44.4	90.5	371.6	2.9	2.9	Buy
Top Glove	10.90	15.15	3308.2	542.2	19.6	15.3	16.2	1.2	15.5	25.7	82.8	4.4	4.4	Buy

INDUSTRY

Global demand rising 10bn pieces a year. We gather from rubber glove manufacturers that the global rubber glove demand last year (2009) should have totaled about 140bn pieces p.a. and is expected to grow by another 7%, or 10bn pieces, in 2010. On top of this, growing health awareness after the H1N1 pandemic is also estimated to boost demand by another few billion pieces a year, which should bring total demand to more than 150bn pieces this year.

Figure 1: Global demand for rubber gloves



Source: OSK, various companies

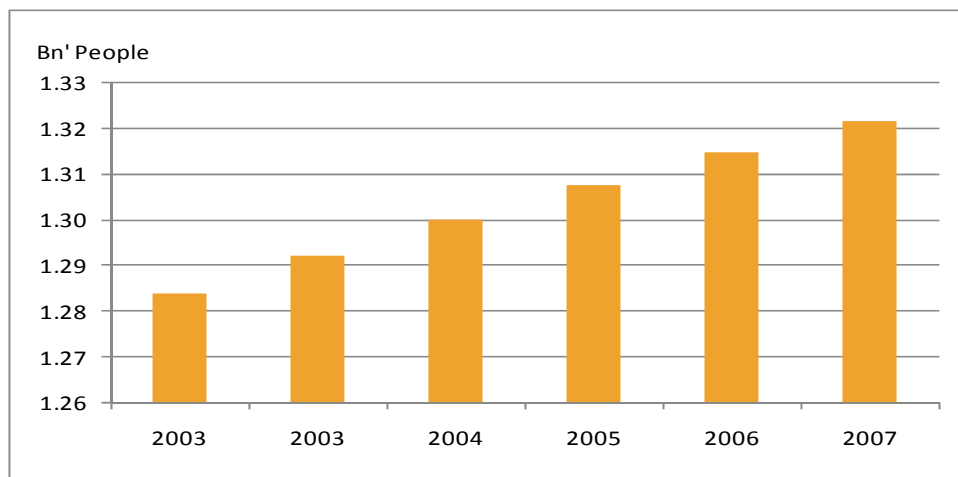
Demand still outpaces supply. We believe that demand is overwhelming supply as demand for 2008 came in at about 130bn pieces but there was hardly any capacity expansion on the part of rubber glove manufacturers owing to uncertainties over the health of the global economy. The industry believes the new capacity in the global market is less than 5bn pieces, which has given rise to the current global shortage of rubber gloves. In the shorter term, most rubber glove manufacturers also expect the supply shortfall of rubber gloves to persist because the industry has not been able to obtain new natural gas supply. Hence, any expansion would mostly be limited to the scrapping of old production lines and adding new lines to their existing facilities to utilize the available natural gas. Also, if glove makers were to turn to biomass as an alternative, it would take too long - about 12-15 months - to get a boiler ready for use. As a result, we see tight glove supply in 1H2010 before new capacity starts kicking in.

Nitrile glove demand has normalized since mid-2008. In 2008, most rubber glove manufacturers were focusing on nitrile glove production targeting the big healthcare MNCs. The nitrile glove is perceived to be a better quality glove and is suitable for use in the medical industry given that it does not cause protein allergy, is more chemical-resistant, and is highly oil-resistant. However, when the global economic crisis started in mid-2008, all their customers including these big healthcare MNCs, altered their mode of doing business by buying more frequently but at a lower quantity. This had somehow slowed down the demand for nitrile gloves, while the non-healthcare MNCs started to look for cheaper alternatives such as natural rubber gloves, which are about USD3.00-USD5.00/1,000 pieces cheaper. Also, these established healthcare MNCs already have dedicated rubber glove suppliers that they would rarely change due to medical quality requirements concerns. Hence, it is not easy to break into the segment of established healthcare MNCs if a company is not already supplying to them in the first place.

Developing countries the next growth market. Brazil is a good example of a market where the surge in demand was mainly driven by 3 factors: 1) the Brazilian government tightened regulations by requiring each glove entering the country to carry the name of the manufacturer, which the smaller glove makers are unable to implement immediately; 2) the spread of the H1N1 pandemic, and 3) increased awareness of glove usage. This exceptionally strong demand has mainly benefited Top Glove and Supermax, which command about 40% and 30% respectively of the entire Brazilian market. Going forward, the developing countries would be the growth market for rubber glove manufacturers since demand from these countries' healthcare MNCs is stable.

Focus back on basic natural rubber gloves. Lately, we understand that all rubber glove manufacturers including Hartalega, which is the market leader in nitrile gloves, are progressively shifting their focus towards natural rubber gloves for capacity build-up targeting the developing countries. This is because the industry believes that once the Chinese and Indian governments implement stringent healthcare requirements in following the footsteps of the Brazilian government, there will be an instant surge in demand for natural rubber gloves, especially powdered gloves, which are the cheapest and entry-level medical grade gloves, given their large populations. Some of the noticeable moves by our rubber glove manufacturers include: 1) Both Top Glove and Supermax continue to concentrate on what they do best, which is to produce NR powder gloves, which make up more than 50% of their product mix; 2) Kossan's future expansion of 16 out of its 32 new lines would be dedicated to the production of NR powder gloves, and 3) Hartalega may consider increasing its NR glove product mix from 30% now to 40% in future.

Figure 2: China's population on rising trend



Source: OSK.

Governments playing a big role in boosting demand for medical grade rubber gloves. When the H1N1 pandemic spread across the world, governments worldwide started to request players in the healthcare industry to stock up on gloves for emergency use, resulting in abnormal profits for all rubber glove manufacturers in 2QCY09. Next, the move by the US and Brazilian governments in tightening the Food and Drug Administration (FDA) requirements by implementing more stringent quality control on rubber gloves used in the medical industry had indirectly weeded out the smaller rubber glove manufacturers which did not have the capability to fulfill the new requirements. This has again benefited all our local rubber glove manufacturers given Malaysia's market leadership in supplying 60-70% of the world's rubber gloves.

US market demand trending up. Yesterday, we attended an analyst briefing by Top Glove and gather from its US representative that the demand for medical gloves as a whole has been increasing lately. This increase follows the practice of better hygiene among its population after the H1N1 pandemic. Also, demand for gloves from the hygiene sector - such as those involved in the provision of spa facilities, manicure, pedicure, tattooing and hair styling services - has also spiralled. This indicates that the use of glove has increasingly become a part of the population's daily life.

CAPACITY EXPANSION BACK TO THE FORE

Expansion in motion. 1H08 to 2009 was a very quiet period in terms of capacity expansion for rubber glove manufacturers. Almost all of them have agonized over their minimal capacity expansion plans but most have not seriously undertaken expansion until recently. With the further signs of recovery in the global economy coupled with the emergence of new virus such as H1N1, rubber glove manufacturers got motivated enough to resume capacity expansion.

Top Glove. Currently, it has a total capacity of 355 production lines capable of producing 31.5bn pieces of gloves p.a. At the analyst briefing yesterday, Top Glove said it expects to increase capacity by another 4bn pieces p.a. by end-2010 (via Factory 18, Factory 20 and Factory 21) and another 3bn pieces p.a. by end-2011 by putting in 32 new production lines on land and building acquired from the former APLI with a total area of 5 acres in Ipoh. Besides rubber glove production, it also plans to expand the capacity of its latex concentrate plant from 78.5k tonnes to 88.1k tonnes to ensure there is enough latex to meet 60%-70% of its latex requirement.

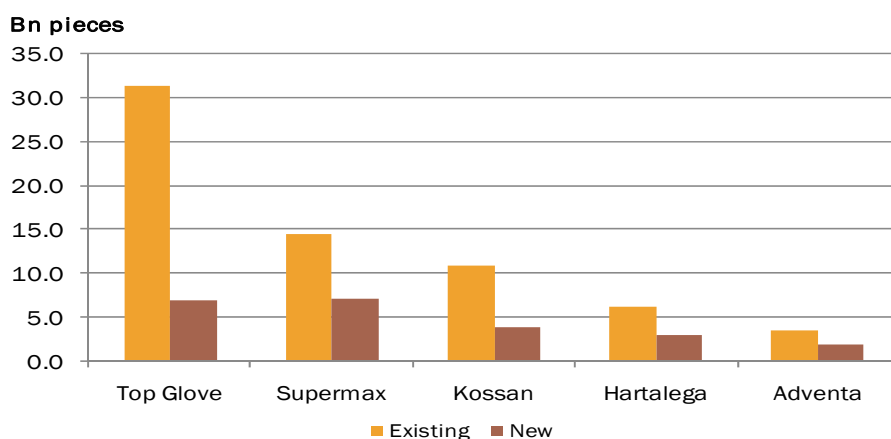
Supermax. Currently, its total annual capacity is at 14.5bn pieces p.a, which management expects to increase by 3.1bn and 4.1bn pieces p.a. by 2010 and 2011 through organic growth. Total annual capacity is expected to hit 21.7bn pieces by end-2011, especially after the commencement of the initial phase of its Glove City project.

Kossan. Currently, its total capacity p.a. is about 11.0bn pieces p.a. and management expects to increase it to 14.5bn pieces p.a. by end-2010 by upgrading some of its existing old lines and commissioning 32 new lines on 22.5 acres land acquired in 2005.

Hartalega. Currently, its total glove production stands at 4.3bn p.a., with a production mix of 70% nitrile gloves and 30% latex gloves for OEM customers. For 2010, the company expects to add another 10 lines, or 2.2bn pieces of gloves p.a, at its new Plant 5.

Adventa. Currently, it manufactures about 3.6bn pieces p.a and by end-2010, management expects to boost total capacity by over 50%, or 2.0bn pieces p.a, to 5.6bn pieces. Note that its total capacity base is small because its core business is still in producing surgical gloves, which is the highest quality grade glove. Adventa currently can only produce 250m pairs due to the stringent quality requirements to fulfil, and thus takes a longer time to manufacture compared to other examination gloves. Besides the slight increase in capacity for its dental and examination gloves, the bulk of the increase comes from new nitrile glove production, starting with 1.5bn pieces p.a. in 2010.

Figure 3: Existing and new production capacity of rubber glove manufacturers

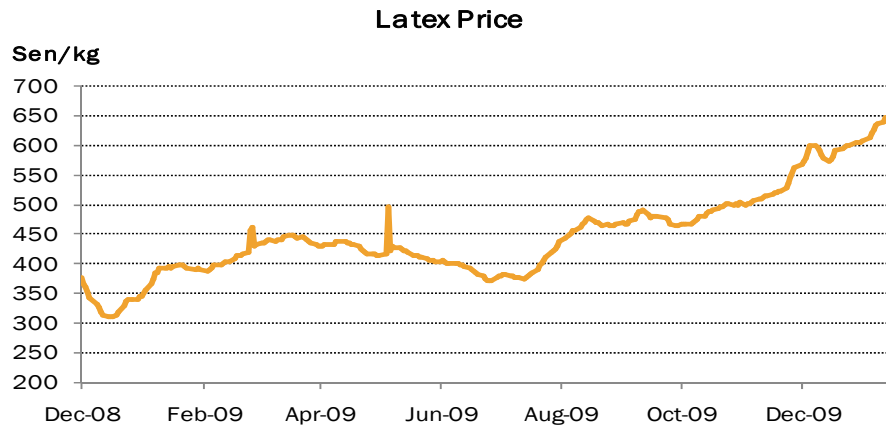


Source: OSK, various companies

ALL GEARED UP FOR HIGHER PRODUCTION COST

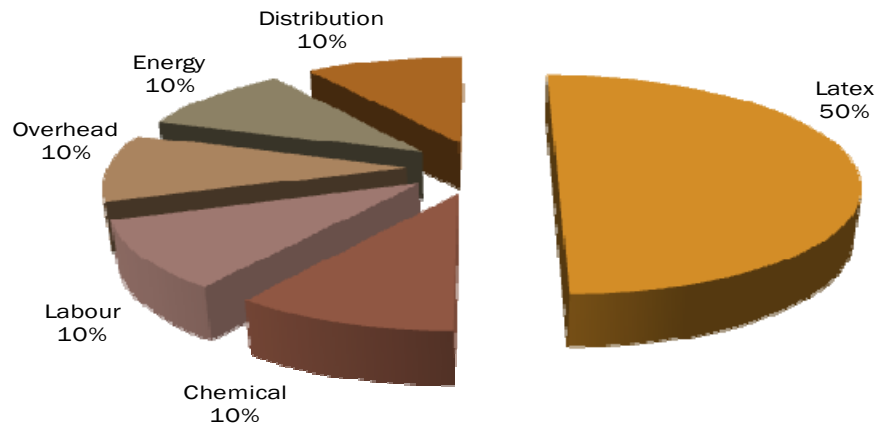
Latex price on the rise. Latex price has been on a rising trend in tandem with the rise in crude oil price. This cost element is quite significant as it makes up about 50% of the rubber glove makers' total production cost, with chemicals, labour, overheads, energy and distribution costs making up the balance. Nevertheless, the rise in production cost is different now compared to mid-2008 when latex price peaked at RM7.20/kg as rubber glove makers are able to more easily pass on the cost increase to their customers due to the strong global demand. In fact, some even pass on the additional cost increase to their customers ahead on anticipation of a further rise in production cost. Some customers do in fact accept this simply because it is more of a seller's market than a buyer's market now. Also, we gather that the lag time has been narrowed to 1-2 months (previously 1-3 months), depending on the terms of shipment with their customers due to the strong demand for rubber gloves.

Figure 4: Latex price on the rise



Source: OSK, Bloomberg

Figure 5: Cost breakdown for glove makers



Source: OSK, Various companies

Ready for production cost increase. Apart from passing on the cost increase to customers, we believe the rubber glove manufacturers are prepared for higher latex prices as they had since early 2008 been progressively putting in efforts to enhance production efficiency when latex price was spiking and adversely affecting their performance quarter after quarter. For example, through production efficiency most of the players were able to reduce the following while maintaining their existing production capacity: 1) natural gas costs lowered by about 5%; 2) electricity cost down 5%-7%, and 3) overheads cost lower by 5%-10%. These have led to margin improvements, if other cost structures remain the same.

VALUATION AND RECOMMENDATIONS

Maintain Overweight on the sector. We are also raising the PER valuation for the entire rubber glove sector from an average PER of 12x to 15x on: 1) persistently strong demand for rubber gloves from the medical and hygiene markets; 2) increase in health and cleanliness awareness following the H1N1 pandemic; 3) a high possibility of governments in developing countries implementing compulsory use of gloves, especially for the medical market; 4) a recovery in the global economy which will ultimately lead to higher living standards across the globe, and 5) local rubber glove manufacturers embarking on capacity expansion again to boost revenue and profits. We believe an upward re-rating on the PER valuation of the sector is timely given the prevailing market sentiment and continuously strong global demand for medical rubber gloves. Traditionally, as Top Glove traded as high as PER of more than 25x, we believe allocating a minimum increase in 2x PER valuation to 17x would not be too demanding. Its peers are still trading below their historical high at their current share prices.

Figure 6: Revised target prices of rubber glove companies

Stock	Previous Call	Previous Target (RM)	Previous FY10/11 PER Valuation (x)	Current Call	Current Target (RM)	Current FY10/11 PER Valuation (x)
Adventa	Buy	3.58	10	Buy	5.37	15
Hartalega	Buy	6.96	12	Buy	8.12	14
Kossan	Buy	6.80	10	Buy	9.52	14
Supermax	Buy	5.30	10	Buy	7.94	15
Top Glove	Buy	11.24	15	Buy	15.15	17

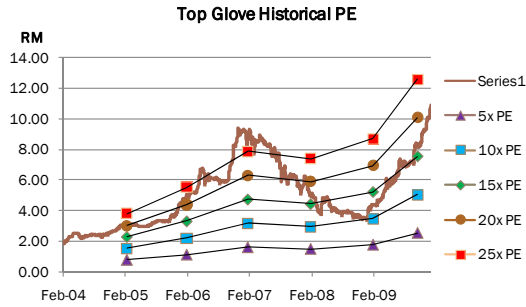
Source: OSK

Top Glove, Supermax and Kossan remain the top picks. We like Top Glove's world market leadership and its good product mix (80% of which is natural rubber gloves), which are the basic and entry level examination rubber gloves targeting the developing countries. We believe demand from these countries would be the growth driver of rubber glove companies going forward. Supermax, the world's second largest rubber glove producer, also has a product mix similar to Top Glove's, and is also targeting the developing countries. Finally, Kossan stands out as a balanced rubber glove manufacturer with a neutral mix of natural rubber and nitrile gloves targeting all markets.

APPENDIX

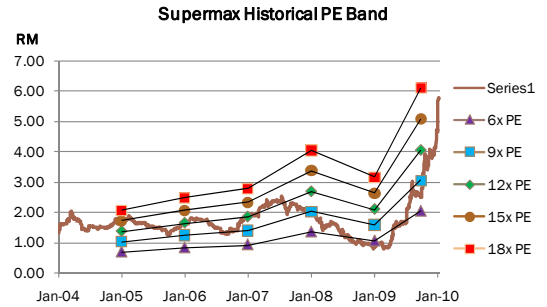
Historical PE Band

Figure 7: Top Glove



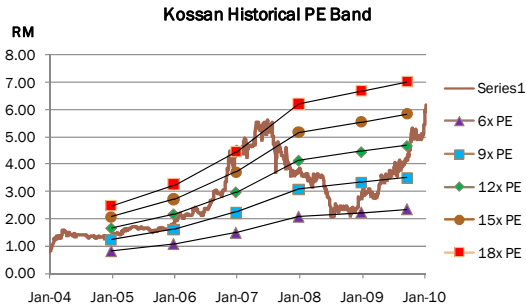
Source : OSK, Top Glove

Figure 8: Supermax



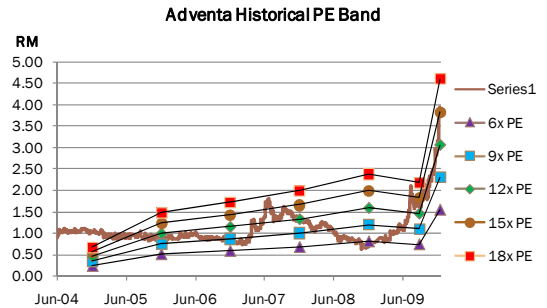
Source : OSK, Supermax

Figure 9: Kossan



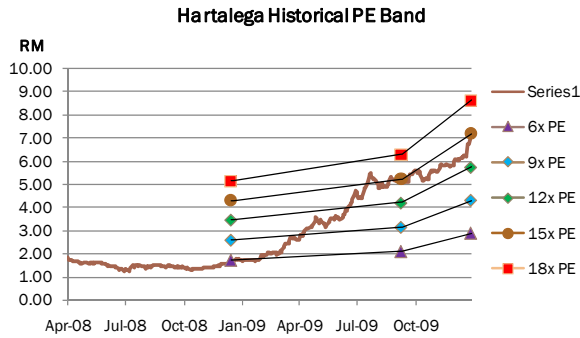
Source : OSK, Kossan

Figure 10: Adventa



Source : OSK, Adventa

Figure 11: Hartalega



Source: OSK, Hartalega

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Buy: Share price may exceed 10% over the next 12 months

Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain

Neutral: Share price may fall within the range of +/- 10% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels

Sell: Share price may fall by more than 10% over the next 12 months

Not Rated (NR): Stock is not within regular research coverage

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Published and printed by :-

OSK RESEARCH SDN. BHD. (206591-V)

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