Rubber Gloves | MALAYSIA

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Jacinda Loh +60 3 2027 6889 jacinda.loh@nomura.com

RUNNING THEME

Action

In conclusion to a round of company visits within our glove universe, we discovered that: 1) competitive concerns appear to rank lower than demand concerns, while utilisations are in a range, starting with Top Glove's 70%; 2) demand normalisation does not equal y-y demand erosion; 3) competition does spell pricing pressure, but this may be unsustainable in the longer term, and; 4) upcoming margin contraction may see margins revert to long-term sustainable levels.

Catalysts

Latent demand from China and India and continued flow-through from US healthcare reform.

Anchor Themes

Structural demand growth still evident, despite expected margin contraction arising from abnormally high latex prices and ringgit appreciation.

Stocks for action

Valuations are now 7-10x P/E, while structural demand still appears evident. We prefer larger glove companies owing to diversified revenue bases and margin resilience amid headwinds.

Stock	Rating	Price (RM)	Price target
Top Glove (TOPG MK)	BUY	5.29	7.71
Supermax (SUCB MK)	BUY	3.99	7.00
Kossan Rubber Industries (KRI MK)	BUY	2.99	4.76

Prices as at 23 September, 2010.

Did we miss the fat lady singing? (II)

① Demand "normalisation" really means normalisation off H1N1 peaks

Top Glove management indicates that on a pre- and post-H1N1 comparison (ie, ignoring the effects of H1N1 beginning from April 2009), overall volumes are up 25%, while Kossan still expects to sell an extra 12% by volume this year. Supermax sold 9% more gloves in 2Q10 versus 1Q10, and saw volumes up 20% on a pre- and post-H1N1 comparison (geographical growth breakdown attached within). We focus more on output / pieces of gloves sold, as we believe that is an efficient indicator of underlying demand, which on a normalised basis, is up in FY10 versus FY09. The above underlying demand strength, we believe, has largely been overshadowed by high latex prices and ringgit-appreciation concerns.

② We expect upcoming sequential earnings contractions for Supermax and Top Glove, but not Kossan

After the company visits, we came away with a view that the upcoming quarter could signal a bottoming out of earnings contractions. We think high latex prices (up 20% y-t-d and up 5% between May–July), and moderating demand (as customers work off high inventory build from H1N1), are likely to cause 13-24% q-q earnings contractions for Supermax and Top Glove, respectively, in upcoming results. However, Top Glove is seeing a slight revival in orders for October-December and Supermax and Kossan reports lead times of 60 days currently. Given Kossan's historically conservative expansion and product differentiation focus, we expect margins to remain resilient for the next two quarters.

③ Competition puts the heat on, but he who laughs last, laughs best

All three glovemakers acknowledge that pricing pressure is evident, although signs of an all-out price war are not currentlly evident. Given the level of pass-through for Top Glove and Supermax is circa 70% currently, this implies potentially lower pass-through for smaller players, who, as we highlighted in our initiation report, may have less resilient margins than bigger players. There may be potential for further industry consolidation (à la the 2005 ringgit de-pegging period) if current conditions persist.

Analyst

Jacinda Loh
+60 3 2027 6889
jacinda.loh@nomura.com

Drilling down

Demand normalisation for Top Glove off H1N1 peak; Kossan and Supermax seeing sequential growth in demand

Normalised volumes up 25% overall, although sequential decline of 5% seen for Top Glove

Top Glove is seeing its output down 5% in the current quarter versus the beginning of the year when, owing to many customers having excess stock in the aftermath of the H1N1 outbreak. This suggests a normalisation off H1N1 peaks, although, as per Exhibit 1, on a pre-and post-1N1 comparison of volumes (current period versus March 2009), volumes to the US are up by 50% and volumes to Europe are up by 20%. That means, ignoring the effects of H1N1 which happened after March 2009 (which would not present a meaningful comparison), overall volumes are up 25% for Top Glove.

Lead time is about 40 days with 70% utilisation for Top Glove.

Exhibit 1. Current demand vs March 2009 prior to H1N1 for Top Glove, average volumes up ...

	US	Europe	Brazil
% growth in output	50%	20%	0%

Source: Top Glove

Exhibit 2. … Supermax has similar 20% growth in average volumes, but no sequential contraction

	(In mn pcs)	Sold per quarter	Average per month
1Q09	Brazil	449	150
	North America	1,258	419
	Europe	779	260
1Q0	Brazil	481	160
	North America	1,346	449
	Europe	833	278
2Q10	Brazil	536	179
	North America	1,502	501
	Europe	930	310

Source: Supermax

Supermax sees similar normalisd 20% volume growth, but expects upcoming output to hold at 2Q10 levels

In our 2Q10 results note for Supermax, we highlighted that it managed to sell 9% more gloves sequentially in 2Q10. The more detailed table above provides the breakdown of glove sales to its three major markets. In all, glove demand continued to grow sequentially and on a pre- and post-H1N1 comparison. The company expects the upcoming 3Q10F output to hold at 2Q10 levels as utilisation rates remain at 80-90% levels with 60-75 days lead time.

Exhibit 3. Kossan still on track to sell 12% more gloves this year

	Output	Comments
FY09	8.5bn pcs	Achieved in FY09
FY1F	9.5bn pcs	Targeted
As of 1H10	4.7bn pcs sold	Sold so far

Source: Kossan

Kossan is on track to meet its 12% growth in gloves sold

Kossan, historically more conservative in its expansion plans, expects to sell 12% more gloves this year versus FY09, and had already met 50% of this target as at 1H10. Management highlighted that it is on track to meet the full-year expected volume growth as its visibility is about two months forward.

Moving forward, demand visibility most clear for Kossan, followed by Supermax and Top Glove

Moving forward on demand visibility, Supermax is seeing orders pick up from Europe as most of its customers return from summer holidays and as they run down inventory levels. Top Glove is seeing a slight pick-up for October-December delivery, while Kossan expects output to hold at recent levels, as it is running at maxed-out capacity with two months visibility.

We believe this is a fact that appears to have been overshadowed by recent negative sentiment — core normalised demand (using output growth as an indicator) was up for all thee glovemakers, implying a continuation of an unbroken trend of annual demand growth for the past 10 years.

The fact that core normalised demand was up for all three glovemakers may have been overshadowed by recent positive sentiment

Sequential earnings contractions expected for Top Glove and Supermax, but not Kossan

In view of circa 70% cost pass-throughs currently for Top Glove and Supermax, we expect a 2-3% margin contraction, to circa 11-12% (its full year) and 16% (3Q10) net margins, respectively (sustainable net margins for both have been at 10-11% and 15-16%, respectively). While Supermax does not plan to delay its expansion pipeline for the moment, it has seen some inevitable delays, as it was unable to procure parts for its lines.

For Top Glove and Supermax, potential for 24% and 13% sequential contractions in NPAT and 2-3% margin contraction

We do not expect Kossan to see similar margin contractions since it earlier put in place a product differentiation strategy (Chemax glove) to protect it from situations such as these (eg, pricing pressure), which appears to have paid off as evidenced in its 2Q10 results, where margins held firm. Prices for its gloves are now up some 15% versus the beginning of the year (latex appreciated 20% y-t-d) amid steady demand growth. Management also has no plans to add in fresh capacity until the end of the year to avoid any idling capacity.

We expect Kossan's margins to stay firm, following management's product differentiation strategy

Exhibit 4. Full-year net margins likely to fall to sustainable net margin level, as all-time high latex prices erode any margin upside

	Sustainable historical net margin (%)
Top Glove	10-11%
Supermax	15-16%
Kossan	10-11%

Source: Respective companies

Competition puts heat on — but small players may find it unsustainable

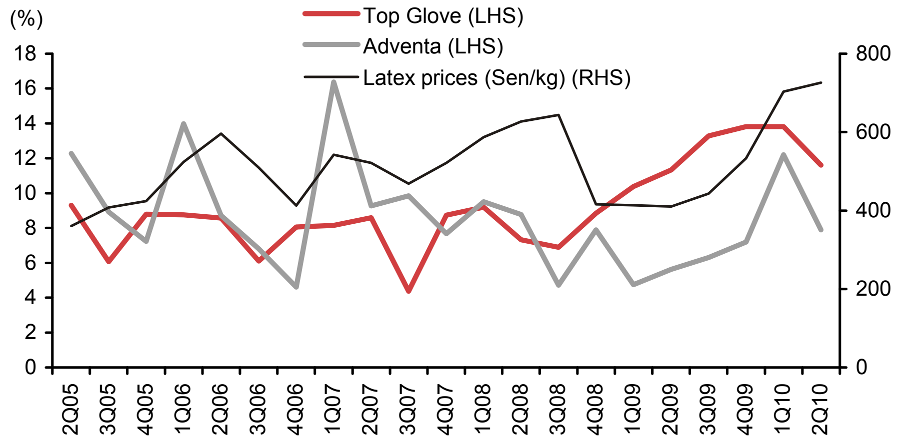
Top Glove's management sees the competitive landscape being dotted by mostly smaller players, with about 4-5bn pieces in capacity, that have no choice, in the face of moderating demand, but to cut prices in order to fill capacity. Given the pass-through is about 70% for Top Glove and Supermax, this implies that the level of pass-through is likely less for the smaller players, who have less ability to sustain this through the long-term. However, the glove players acknowledge that this definitely puts the pricing pressure on, as evidenced by the less than 100% cost pass-throughs.

Smaller players will be forced to cut prices to fill capacity, and this will hurt them more than the bigger players

Observing the period between 2005-2008 below, we highlight that bigger players generally have more resilient margins, while the de-pegging of the ringgit in 2005 also spurred a round of consolidation in the industry (from 107 then to 56 players today).

Should unfavourable conditions persist, we do not rule out further industry consolidation

Exhibit 5. In our initiation report, we highlighted the same example below – bigger players have more resilient margins



Source: Respective companies

Duress at smaller players makes them more likely targets of M&A

There may be a potential for industry consolidation should current conditions worsen, in our view. Similar to investors' feedback that they prefer to remain on the sidelines where glove sectors are concerned for the moment, as near term headwinds persist, Top Glove management is also waiting for an opportunity to go "shopping" — but highlights that it might still be early and will wait until the next few quarters to see if M&A opportunities pop up.

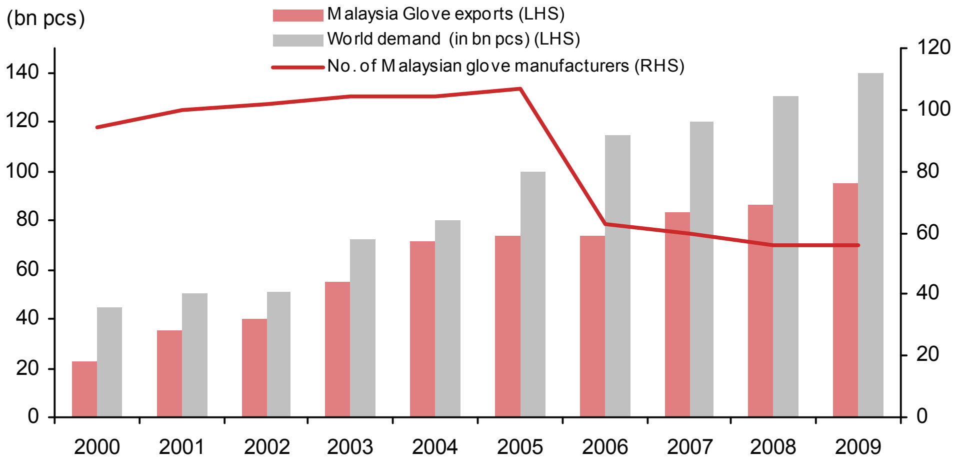
Upcoming results may be the bottom as Supermax highlighted it is seeing demand revival from Europe and Top Glove is seeing slight improvement in October-December delivery, however latex trends need to be watched

Near-term performance may remain weak in the run-up to the next quarterly results season in October (6 October for Top Glove) and November (Kossan and Supermax) and also ahead of the Budget 2011 announcement. However, current share prices seem to imply the possibility of negative EPS growth next year, almost unheard of in glovemakers' listing histories, even during the recessionary year of 2008 (when latex prices and crude oil hit a then all-time high amidst tariff hikes in electricity and petrol). The current uncertainty on the direction of latex prices increases the difficulty of forecasting CY11F demand. However, Top Glove management highlighted that the industry and the customers may end up having to "get used" to the high latex prices and find a new demand equilibrium. As mentioned earlier, Supermax is seeing a revival in demand from Europe while Top Glove is seeing some improvement in October-December delivery. This leads us to believe that the upcoming results (3Q10 for Supermax and Kossan, 4Q10 for Top Glove) may be the quarter where the bottom is reached, with potentially flat performance subsequently (4Q10F and 1Q11F, respectively), assuming latex prices hold at current RM7.20/kg levels.

Also to be fair, recent data points to 20-25% y-y normalised volume increases. However, adverse latex prices and ringgit-appreciation headwinds may indeed demonstrate that a long-term sustainable growth rate of 8-10% (as expected by the glovemakers based on past trends) is still intact.

We believe investors looking for data points to monitor in the coming months could look at the performance of the major cost component, ie: 1) latex price trends, and; 2) the level of rubber futures volumes and prices on the Tokyo Commodities exchange (which influences the pricing of rubber products such as latex).

Exhibit 6. Recent data points (20-25% normalised volume rises) among our glovemakers suggest sustainable growth is intact, headwinds or no



Source: Respective companies

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Kossan Rubber Industries	KRI MK	2.99 MYR	24 Sep 2010	Buy	
Supermax Corp Bhd	SUCB MK	3.99 MYR	24 Sep 2010	Buy	
Top Glove Corp	TOPG MK	5.29 MYR	24 Sep 2010	Buy	

Previous Ratings

Issuer	Previous Rating	Date of change
Kossan Rubber Industries	Not Rated	10 Mar 2010
Supermax Corp Bhd	Not Rated	10 Mar 2010
Top Glove Corp	Not Rated	10 Mar 2010

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