

Healthcare Products - Rubber Gloves

Overweight (Maintained)

Set To Bounce

Macro  
 Risks  
 Growth  
 Value  

We are optimistic on the rubber glove sector as market conditions are tilting in favour of glove makers. We are **OVERWEIGHT** on the sector owing to: i) favourable raw material prices, (ii) the strengthening USD, (iii) minimal impact from a potential natural gas cost hike, and (iv) resilient gloves demand. We have **BUY** calls for Hartalega, Top Glove, Kossan and Supermax.

- ◆ **Results in line.** Of the four companies under our coverage, three recorded healthy June quarter earnings, which came largely in line with our expectations. The numbers were bolstered by softening raw material prices and rising production capacity. However, Top Glove reported disappointing results in the quarter ended May (FYE Aug) due to a shift in demand from natural rubber (NR) gloves to nitrile gloves.
- ◆ **Favourable raw material prices and currency.** We believe the 14.2% YTD decline in raw material prices and the strengthening of the USD to MYR3.30 in Aug 2013 from MYR3.05 in Jan 2013 would bolster glove makers' earnings margins moving forward.
- ◆ **Natural gas hike to have minimal impact.** We believe that a potential hike in natural gas will have a minimal impact on glove makers as energy costs only make up 8% to 10% of total production costs. Glove makers can use biomass energy to mitigate the increase in energy costs.
- ◆ **Glove demand still resilient.** We believe that rubber gloves demand will remain intact over the next few years due to a shift in preference towards synthetic nitrile gloves. Shipments of nitrile gloves to the US surged to 31.8bn pieces in 2012 from just 5.3bn pieces in 2003.
- ◆ **Maintain OVERWEIGHT.** We continue to like the rubber gloves sector as the operating environment is turning favourable. Thus, we have BUY recommendations for Hartalega (HART MK, FV: MYR7.95), Top Glove (TOPG MK, FV: MYR7.08), Kossan (KRI MK, FV: MYR7.53) and Supermax (SUCB MK, FV: MYR3.01).

Company Name	Price	Target	P/E (x)	P/B (x)	Yield (%)	Rating
			Dec-13F	Dec-13F	Dec-13F	
Hartalega	MYR7.04	MYR7.95	19.6	5.8	2.3	BUY
Kossan Rubber Industries	MYR6.78	MYR7.53	15.0	3.1	2.0	BUY
Supermax	MYR2.71	MYR3.01	12.4	1.9	2.4	BUY
Top Glove	MYR6.20	MYR7.08	17.2	2.6	1.9	BUY

Source: Company data, RHB estimates

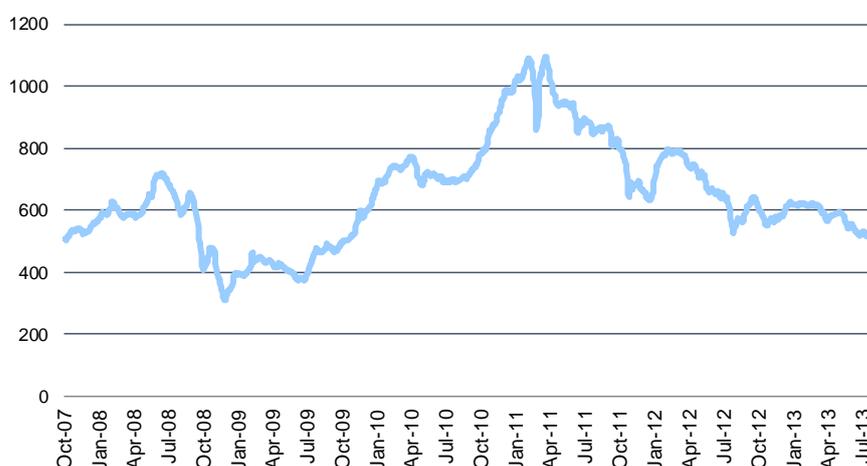
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2QFY13 results in line. The rubber gloves sector registered healthy results for the quarter ended June that were well within our expectations. Three of the four rubber glove stocks under our coverage - Hartalega, Kossan and Supermax - delivered commendable 1HFY13 bottomlines, mostly boosted by easing prices of raw materials such as natural rubber latex and nitrile, as well as rising production capacity. However, Top Glove (FYE Aug) came in below our expectations, mainly attributed to lower demand for its latex gloves as customers shifted to nitrile, which led to pricing pressure for natural rubber (NR) gloves.

Capacity expansion to drive earnings. Going forward, we expect the glove companies' expansion plans to propel earnings growth. Both Kossan and Supermax are focusing more on the higher-margin nitrile glove segment, targeting to increase their nitrile capacity by 1.4bn pieces and 6.4bn pieces by end-2013 respectively.

Favourable natural latex prices. As natural latex price eases, we believe that natural rubber glove makers will be able to maintain healthy earnings margins. Natural latex prices have dropped 14.2% YTD to MYR5.23/kg currently. Going into 2HFY13, we expect natural latex price to consolidate within the MYR4.50-5.50/kg range on the back of rising supply from Thailand and Cambodia, softer auto sales growth in China, as well as slowing demand for natural latex amid a sluggish global economy.

Figure 1: Monthly latex price movement (MYR sen/kg)



Source: Malaysian Rubber Board

Figure 2: Sensitivity analysis for increase in latex prices

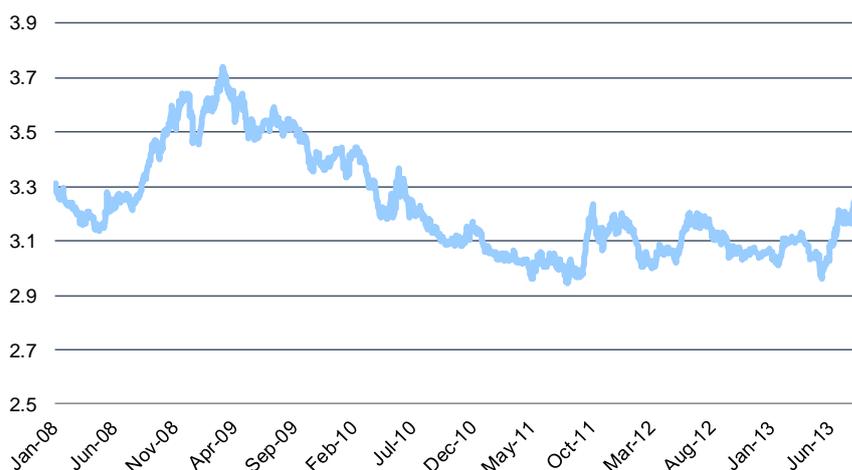
Company	Ticker	Net profit (MYR m)	Latex price/kg	Variance (%)
		FY14f	+MYR0.50	
Top Glove	TOPG MK	257.5	163.6	-36.5%
Hartalega	HART MK	270.2	229.7	-15.0%
Kossan	KRI MK	172.6	133.1	-22.9%
Supermax	SUCB MK	166.6	141.4	-15.1%

Source: RHB estimates

Nitrile prices easing too. The price of nitrile latex, which is made up of nitrile butadiene rubber and other chemicals, has also fallen, easing to MYR4.03 per kg in July 2013 from MYR5.54 per kg in Jan 2013. This is good for all the rubber glove players as most of them are ramping up nitrile gloves production. We expect nitrile prices to remain at these levels, thus allowing nitrile glove makers to maintain wholesome margins going forward.

Strengthening USD a short-term positive. Currently, the MYR - along with other emerging market currencies - has weakened against the USD as investors redirect their investments to the US following the Federal Reserve's announcement to taper off its quantitative easing programme. The MYR is now trading at about MYR3.30 to the USD, down 8.2% YTD. A stronger USD vis-à-vis the MYR benefits glove makers as most of their products' ASPs are denominated in dollars. That said, we believe the positive impact would be short term as glove makers regularly hedge against currency fluctuations, which should smoothen out any positive or negative impact.

Figure 3: Monthly USD/MYR price movement



Source: Bloomberg

Figure 4: Sensitivity analysis for an increase in USD/MYR

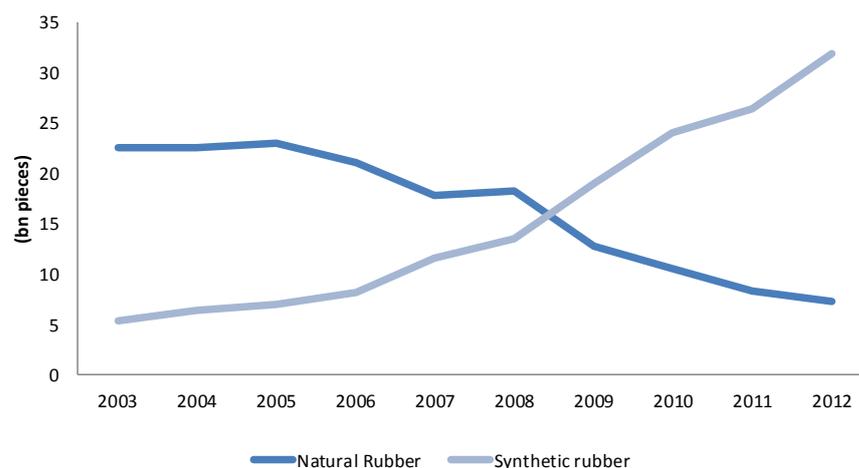
Company	Ticker	Net profit (MYR m) FY14f	USD/MYR +MYR0.10	Variance (%)
Top Glove	TOPG MK	257.5	311.5	21%
Hartalega	HART MK	270.2	295.7	9%
Kossan	KRI MK	172.6	199.6	16%
Supermax	SUCB MK	166.6	184.6	11%

Source: RHB estimates

Gas price to go up? This month, the Malaysian Government raised petrol prices in what is seen as a first step to rationalize its subsidies, with more fiscal consolidation measures likely to be proposed in its 2014 Budget. We believe that glove makers may potentially face higher production costs from an increase in energy prices. Natural gas price was first raised to MYR13.70/mmbtu (million metric British thermal units) from MYR10.70/mmbtu in June 2011, followed by a gradual increase of MYR3.00/mmbtu every six months until it reaches market parity in 2016. However, there has been no further progress since the last assessment in Dec 2011. That said, we believe that the impact of higher gas prices on glove makers will be minimal as energy costs only make up about 8-10% of their total production costs. In addition, glove makers can mitigate the impact by using biomass energy as an alternative to natural gas.

Glove demand to stay resilient. We expect the annual demand for rubber gloves to remain steady at 10% growth over the next few years, mainly driven by solid demand for nitrile-based gloves, although we expect latex-based gloves to continue to chalk up positive sales growth as raw material prices eases. The shipment of synthetic gloves to the US surged to 60.9% in 2012 from 16% in 2003. According to glove makers, utilisation rates for nitrile production stand at 85-90%, with oversold positions of up to 90 days. This means that capacity is ordered at least three months in advance.

Figure 5: US glove imports trend from 2003 – 2012



Source: RHB, Hartalega

All-round capacity expansion. As demand increasingly shifts to synthetic gloves, glove makers are responding by boosting their capacity for nitrile production. Hartalega is building its next-generation integrated glove manufacturing complex (NGC), with its first line expected to begin construction in Aug 2014. This will bolster its overall capacity to 43bn pieces in 2020. Meanwhile, Top Glove plans to increase its nitrile glove production capacity to 47.9bn pieces annually (from 41.9bn pieces). As of June 2013, the company's production mix comprised 73% natural latex and 18% nitrile.

In the meantime, Kossan and Supermax are also bolstering their nitrile gloves production capacity. Upon completion in May 2014, Kossan's annual production capacity will go up by 31% to 22bn pieces while Supermax's nitrile capacity will more than double its annual capacity to 12.3bn pieces by 1QFY14. We are positive on nitrile expansion as nitrile demand is set to rise at 18-20% annually.

Maintain OVERWEIGHT. Given the current market conditions, we are revising our assumptions for all four companies under our coverage to incorporate the strengthening USD vs MYR, as well as the latest hike in petrol prices in Malaysia. All said, the downtrend in raw material prices and strengthening USD reinforce our positive stance on the rubber gloves sector. We remain OVERWEIGHT on the sector, with BUY recommendations for Hartalega (HART MK, FV: MYR7.95), Top Glove (TOPG MK, FV: MYR7.08), Kossan (KRI MK, FV: MYR7.53) and Supermax (SUCB MK, FV: MYR3.01).

Figure 6: Changes in fair value and net profits

	Fair Value (FV)		FY13 net profit (MYR m)		FY14 net profit (MYR m)	
	Old	New	Old	New	Old	New
Top Glove	7.01	7.08	204.5	205.2	255.2	257.5
Hartalega	8.04	7.95	235.0	235.0	267.9	270.2
Kossan	7.38	7.53	133.4	144.5	169.0	145.5
Supermax	2.84	3.01	137.9	144.6	156.9	166.6

Source: RHB estimates

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