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Sector Update

Rubber Gloves

NEUTRAL

Negative Impact From Normalizing Demand

The rubber glove sector has been experiencing normalizing demand since the start of 2H10 when the H1N1 pandemic lost its influence as a factor driving demand growth and as new capacity started to flood the market. As rubber glove manufacturers were unable to pass on to their customers all additional cost increases arising from higher latex prices and an unfavorable USD-MYR exchange rate, most saw their margins as well as absolute bottom lines being compressed. In light of these developments, we are downgrading the sector to Neutral from Overweight.

Why downgrade? Our downgrade is on the basis that the demand for examination rubber gloves has normalized. As such, rubber glove manufacturers would not be able to pass on to their customers all the negative effects associated with high latex prices, an unfavorable exchange rate and other cost increases. This has in turn impacted on their margins and absolute bottom-line targets.

Why Neutral? We are downgrading our call to Neutral rather than Underweight because we believe the magnitude of the recent selldown of rubber glove stocks is not justifiable. The share prices of these stocks have been bashed down by between 20%-40% despite the fact that rubber glove companies were still delivering profitable quarterly numbers in the face of unfavorable factors that were beyond their control such as high latex prices and the strengthening of the ringgit against USD, and were not encountering operation problems from within. Also, most of the glove stocks were not trading at their historical high PEs of about 15-18x even when their share prices were at a year high. While it can be argued that the glove stocks traditionally did not trade at such continuously high PE valuations, we firmly believe that they also should also not be trading at their current historical low PEs of 6-10x since they have made tremendous progress and now boast of higher production capacity, a bigger clientele and deeper market penetration, higher production efficiency and more importantly, products of high quality due to technological advancements in the medical industry. Hence, we believe the industry should bear with the recent setbacks, which we believe would blow over in the next 6 months, after which we should see the industry making a comeback.

Lowering FY10-11 earnings estimates. We are lowering our FY10-11 earnings for most rubber glove companies mainly to take into account the short term negative effects of normalizing demand for examination gloves.

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	2.47	3.73	358.6	333.4	11.9	7.9	9.2	2.8	-17.0	-30.1	24.1	1.8	Buy
Hartalega	4.70	7.20	1708.5	358.3	11.9	10.0	33.1	4.3	-13.8	-16.3	14.4	2.9	Buy
Kossan	3.12	5.25	997.5	679.8	8.4	7.7	18.7	4.8	-16.7	-18.9	37.8	1.2	Buy
Supermax	4.35	7.84	1442.5	2030.8	7.9	7.2	23.3	2.5	-22.1	-21.1	93.0	2.3	Buy
Top Glove	5.80	6.06	3606.4	1987.0	14.5	14.3	20.5	4.1	-13.1	-20.9	32.9	1.7	Neutral

What has changed?

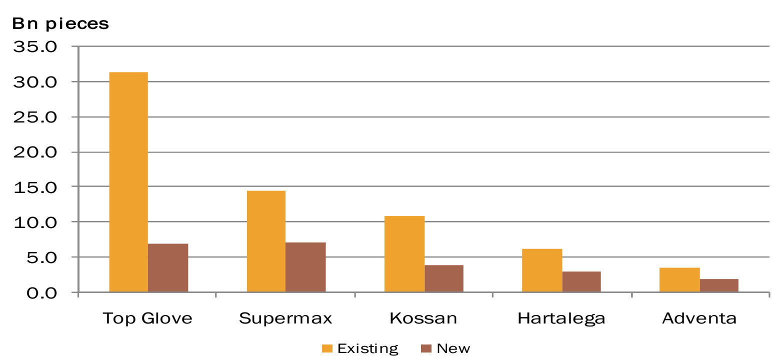
Bigger-than-expected impact from normalizing demand. Firstly, when the demand for examination gloves was very strong, possibly driven by factors such as a new pandemic or healthcare reforms, all rubber glove manufacturers have had no problems passing on cost increases such as those for latex prices or a unfavorable exchange rate. In fact, we understand that some had even passed on more than 100% of the cost increase and in the process reaped extraordinarily good margins. However, we gather that things started changing in mid-2010, during which the anticipated strong growth of examination gloves demand did not materialize, but normalized instead.

What caused demand to normalise. We believe 2 main factors contributed to rubber glove demand normalizing. These are: 1) The H1N1 factor no longer drives demand since most healthcare MNCs are well stocked up by now, and 2) additional capacity is flooding the market. Certainly, the other factors are there being no new major healthcare reforms, more rubber glove manufacturers now meeting the stricter FDA requirements, and slower demand from the Latin American market.

H1N1 no longer a major factor. It has been more than a year since the H1N1 was declared a pandemic. At that time, there was overwhelming demand for examination gloves since most of the healthcare MNCs had kept minimum stocks of gloves following the global economic recession before the H1N1 pandemic. The disease outbreak triggered a wave of massive re-stocking of gloves to make them available to meet the needs of the global population. However, for the time being, almost all the healthcare MNCs have stocked up to levels at which they would be prepared for another pandemic should one occur. This has in turn contributed to a softer demand compared to a year ago.

New capacity coming in. When customers become aware that there is additional capacity in the pipeline and that demand is normalising, they would no longer be willing to absorb the higher prices of the examination gloves arising from higher production cost. In fact, they are more likely to cut back on orders with the more "expensive'' glove supplier and buy from a "cheaper" party. This will be more so in the case of basic examination gloves, which require minimal technology to produce and can easily be duplicated due to the lower FDA requirements imposed on them.

Figure 1: Existing and new capacity of rubber glove manufacturers



Source: Various rubber glove companies, OSK

No new major healthcare reform. Earlier this year, US President Barack Obama approved a healthcare bill that extends insurance coverage to 32m uninsured Americans. Although the impact is not enormous (assuming that an American visits the clinic or hospital twice a month, this bill could lead to higher use of gloves of less than 1bn pieces p.a.) the industry had expected other regions to jump into the healthcare reform bandwagon. However, as we did not see other major healthcare reforms in other countries following in the US' footsteps, the previously strong demand for gloves started to taper off.

More glove makers now able to meet strict requirements. Previously, when the US and Brazilian governments tightened Food and Drug Administration (FDA) requirements by imposing more stringent quality criteria on rubber gloves used in the medical industry, this had indirectly weeded out the smaller rubber glove manufacturers which could not fulfill the new requirements. However, over time many of those that had failed to meet FDA requirements earlier are now passing strict rules after sprucing up their production processes. As the playing field levels, the companies that were initially capable of meeting those strict quality requirements can no longer consider this a competitive strength.

Demand from growing markets back to normal. The Latin American market has been a source of good profits to first movers such as Top Glove and Supermax, especially after the Brazilian government tightened regulations that stipulate that every glove entering the country must carry the name of the manufacturer, a requirement that the smaller glove makers are unable to implement immediately. Currently, we gather that the combined market share of the two companies is about 60%-70%, but as more players enter the market amid weaker glove demand compared to a year ago, our estimate is that this combined share would have dropped close to 50%. Also, as demand normalizes, the selling prices of gloves in that region would not be as attractive as before.

Negative impact from normalising demand in the short term

Not all the cost increase can be passed on. Based on our survey of the top 5 rubber glove manufacturers in Malaysia, we gather that their ability to pass on cost increases (mainly from latex price and an unfavorable exchange rate to some extent) to their customers has weakened to 70%-80% of the costs compared to 90%-110% a year ago when demand was at a peak. This will eventually lead to margins narrowing, possibly back to the historical EBTIDA margins of 12%-15% compared with more than 20% last year. Bottomline-wise, our estimate is that these would be slightly lower if not flat, as the higher cost absorbed by glove makers would be compensated by their higher production capacity (but on the assumption that demand growth remains positive going forward).

Time lag of 2-3 months. Since the examination glove market is gradually turning into a buyer's market, we believe most of the rubber glove manufacturers would not be able to pass on their cost increase immediately or ahead of any increase like they did in the previous year. This is because the ample supply of gloves and the lack of urgency to stock up on the product have swung the bargaining power from glove makers to their customers.

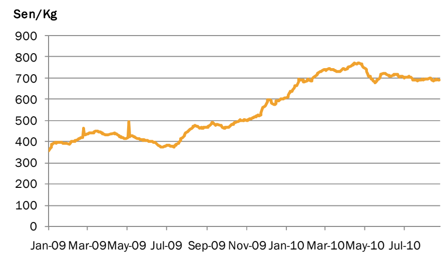
Price war. We believe this is most likely to be initiated by the smaller rubber glove manufacturers who have minimal contracts with the healthcare MNCs, whose orders are more stable. While this would worsen the weakening demand situation, we do not think it would be a protracted one. Instead, it will lead to further industry consolidation whereby the bigger companies will get stronger and the smaller companies become weaker. This may then give rise to merger and acquisition opportunities for the bigger rubber glove manufacturers who have the financial muscle to ride through the normalising demand phase.

Ultimately negative for earnings. We believe the quarterly results of most rubber glove companies would be at best flat q-o-q, if not trend down, in view of these negative developments. Hence, we are revising downwards our FY10-11 earnings for most of the rubber glove companies under our coverage to take into consideration the short term negative impact.

Negative factors making the current situation worse

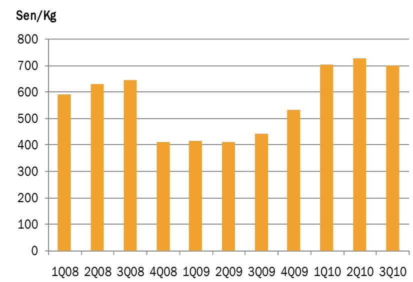
Latex price remains high at about RM7.00/kg. Latex prices affect the earnings of rubber glove manufacturers when: 1) they are on a rising trend; thus glove makers are always trying to catch up with the higher price by passing on the cost increase to their customers, and 2) demand is not strong, which renders it more difficult for glove players to fully pass on the cost increase to their customers. Currently, latex price trend is stable although prices remain high at about RM7.00/kg. However, due to normalizing demand and the expectation of latex price falling back below RM7.00/kg to RM6.00/kg, rubber glove manufacturers can only pass on about 70% of the additional cost to their customers. Hence, this will negatively impact on their earnings.

Figure 2: Latex price still high at RM7.00/kg



Source : OSK, Bloomberg

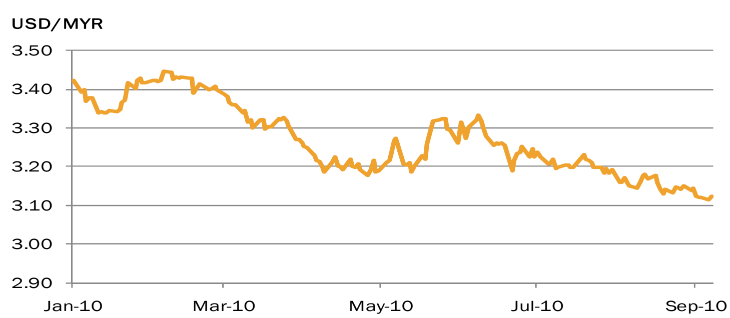
Figure 3: Latex price has not fallen since 1QCY10



Source : OSK, Bloomberg

Weakening USD versus MYR. Generally, most of the rubber glove manufacturers hedge about 50% of their sales and receivables and leave the other 50% unhedged. Also, part of the unhedged amount is offset through natural hedging, whereby the money received in USD will be used to pay latex suppliers. All in, we believe glove makers' unhedged exposure is less than 30%-40% but this would still have a negative impact on their sales and profit as long as the dollar continues to weaken against the MYR. Our house view is for USD/MYR rate to end at 3.16 for 2010 and 3.20 for 2011. Hence, we expect forex rates to be less of a bane for rubber glove manufacturers next year.

Figure 4: Weakening of USD vs MYR

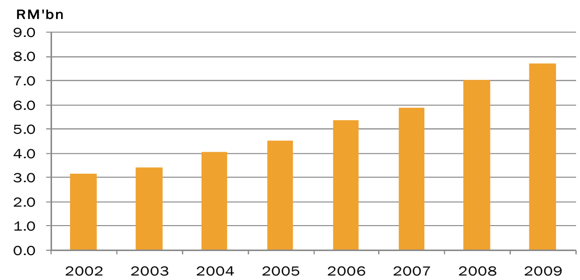


Source: Bloomberg, OSK

But normalising demand is Positive in the longer term

Merger and acquisition opportunities for the bigger players. Although the impact from normalizing demand is negative in the short term, we believe the demand-supply mechanics continue to be positive in the longer term because: 1) examination gloves making is a resilient industry, whose growth is co-related to 2 major factors - population growth and healthcare awareness - which are on a rising trend; 2) there is lack of natural gas supply in the short term and acquiring companies with this resource will be the surest way for future expansion, assuming that the biomass option is not picked. Also, although one can argue that there may be new supply in the future years, we gather from all the rubber glove manufacturers that they have lobbied for additional gas supply for several years but that they have not been given much additional supply, and 3) with less intense competition, the industry will become oligopolistic in nature and hence offer greater opportunities to make bigger profits.

Figure 5: Malaysia's rubber glove exports



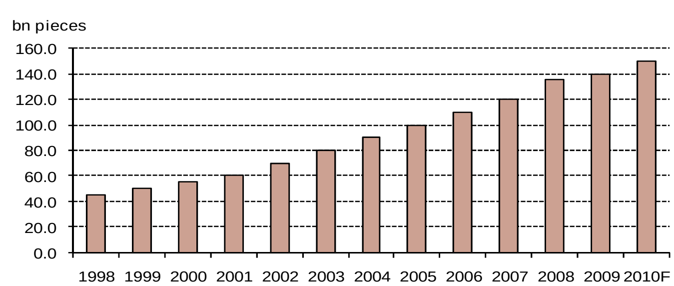
Source: MREPC

Mixed views from managements

Some are still bullish; some bleak. Based on a recent check with the 5 rubber glove manufactures under our coverage, we gather that there are mixed views on the immediate outlook for the sector. Half of the companies are neutral in that they expect flat q-o-q results over the next 2 quarters while the others are slightly bearish and see a drop in their 3QCY10 performance, with a gradual pick-up in momentum in 4QCY10. On next year's outlook, some still expect reasonable growth of at least 10% backed by capacity expansion while the others believe that 2010 will be a better year compared to 2011 on the assumption that latex price continues to remain high and forex remains at their disadvantage.

8%-10% global demand growth forecast intact. Most of them agreed that this projection is intact as it will be mainly driven by growing hygiene awareness rather than any new pandemic or major healthcare reform. That is also the main reason why glove makers are still going ahead with their capacity expansion programs despite the setback in demand for the short term. However, we gather that some players' expansion plans have been delayed due to the supply shortage of formers as a result of the recent spate of aggressive expansion among glove makers.

Figure 6: Global demand for rubber gloves



Source: OSK, various companies

Our view

A more difficult 2H10 expected. We believe the 3Q and 4Q results of most rubber glove companies would at best be flat q-o-q, if not experiencing a drop, given the negative effects arising from normalizing demand for examination gloves. We think there is a possibility that 3Q would be the worst quarter this year and see most of glove makers recovering in 4Q, during which we expect more aggressive stocking up of examination gloves just before the start of the wintering season of rubber trees in early 1H11, which will again drive up latex prices and in turn, the selling prices of gloves.

Outlook for a flat 2011. Unless there is a surge in examination glove demand fuelled possibly by a new health pandemic or major healthcare reform, we see a flat 2011. This is because the revenue base for all the rubber glove manufacturers was large in 1H10 spurred by seemingly insatiable demand and reasonably high selling prices of gloves. That said, this revenue base is expected to normalize in 2H10. Thus, assuming that 2011 revenue will be flat y-o-y, there is technically some growth from the 2H10 level, which will be contributed by higher production capacity.

8%-10% demand growth may not be intact in the short term. A growth of 8 – 10% in demand was the guidance from rubber glove manufacturers last year to early this year, which we believe was premised on strong examination glove demand arising from the H1N1 pandemic, the US healthcare reforms as well as re-stocking to replenish following the global economic recession. For now, we believe the immediate catalyst for demand growth would be the growing awareness of hygiene among the global population following the H1N1 pandemic. Hence, in our view, demand growth is still there, although it would probably be a little lower than the 8%-10% p.a guided earlier, especially in the shorter term since the global economy is still in recovery mode and there is no major healthcare pandemic this year. Our view, however, does not take into account the potential demand arising from healthcare reforms in China and India as our market surveys indicate that this demand may take some time to accelerate.

Valuations and Recommendations

Downgrade to Neutral. Our downgrade is on the basis that the demand for examination rubber gloves has normalized. This means rubber glove manufacturers would not be able to pass on all the negative effects arising from high latex price, unfavorable exchange rate and so on to their customers. This would then affect their margins and absolute bottom lines. Overall, we are also lowering our FY10-11 earnings for most rubber glove companies mainly to take into account the short term negative effects. Also, we are only downgrading our call to Neutral rather than Underweight because we believe the magnitude of the recent selldown in rubber glove stocks is not unwarranted. Their share prices have been bashed down by between 20%-40% although they have been delivering profitable quarter results even in the face of unfavourable factors beyond their control such as high latex price and the strengthening of the MYR against USD. Also, most of the glove stocks were not trading at their historical high PEs of about 15-18x even when their share prices were at a year high. Although one may argue that the glove stocks traditionally did not trade at such continuously high PE valuation, we believe they also should not trade at their historical low PEs of 6-10x since they have made significant strides, what with their higher production capacity, bigger clientele and deeper market penetration, better production efficiency and more importantly, product quality that is in step with advancements in technology in the medical industry. Hence, we believe the industry should bear with these recent setbacks, which we believe will blow over in the next 6 months, after which we think the industry will make a comeback, which would warrant our upgrade on the sector call back to Overweight.

Figure 7: Retracement percentage of share prices from year high

Stock	Year High RM	Current Price RM	Retracement %
Adventa	4.35	2.47	-43%
Hartalega	5.70	4.70	-18%
Kossan	4.28	3.12	-27%
Supermax	6.60	4.35	-34%
Top Glove	7.38	5.80	-21%

Source: Bursa Malaysia, OSK

Figure 8: Valuations of rubber glove companies

Stock	Previous Call	Previous Target (RM)	Previous FY11/12 PER Valuation (x)	Current Call	Current Target (RM)	Current FY11/12 PER Valuation (x)
Adventa	Buy	5.37	15	Buy	3.73	12
Hartalega	Buy	7.93	14	Buy	7.20	13
Kossan	Buy	5.65	14	Buy	5.25	13
Supermax	Buy	9.11	15	Buy	7.84	13
Top Glove	Buy	7.57	17	Neutral	6.06	15

Source: OSK

OSK Research Guide to Investment Ratings

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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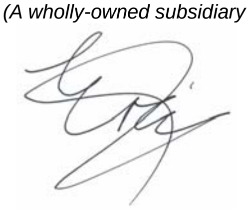

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