

## Hartalega Holdings (HART MK)

### Future Seems Cloudy

We expect pricing and margin pressure to linger within the nitrile gloves segment, stemming from the rapidly growing nitrile glove production capacity. While Hartalega's major expansion phase should eventually reignite its earnings momentum, its growth prospects would be relatively unimpressive through the intermediate term. Maintain SELL with a revised target price of RM4.05 (previously RM3.58).

### What's New

- **A slower growth phase.** We predict that Hartalega would only deliver annual earnings CAGR of 9.8% in FY11-FY15, against its previous past four-year average CAGR of 65.7%. There is downside risk to our assessment as industry capacity utilisation of nitrile gloves is expected to fall significantly when the fast-growing new installed capacity comes on-stream.
- **Nitrile glove segment seems cloudy...** We remain less sanguine over the nitrile gloves segment due to lingering concerns on a) overcapacity; b) slipping margins; and c) decelerating growth.
- **... as demand growth in the US slows.** Volume demand growth in nitrile gloves has registered high 3-year CAGR of 50.3% since 2008, with the US being the biggest largest importer. However, the substitution effect (from natural rubber to nitrile gloves) in the US has slowed significantly (refer to RHS chart overleaf), and the US market will soon be hitting saturation point as usage of nitrile vs latex gloves is already 70:30.
- **NGC yet to commence construction.** Hartalega's RM1.5b mega project Next Generation Integrated Glove Manufacturing Complex (NGC), which is slated to begin construction in 1Q13, is likely to be delayed as we understand that the land purchase is yet to be finalised. To recap, the NGC, spanning over 112 acres land size in Sepang, is set to house additional 70 production lines, which will add 157% to its current production capacity of 11b pcs p.a. over 8 years (based on targeted production line speed of 45k pcs/line/hour).

### Key Financials

Year to 31 Mar (RMm)	2011	2012	2013F	2014F	2015F
Net turnover	735	931	1,046	1,233	1,501
EBITDA	274	299	313	358	413
Operating profit	245	260	271	302	342
Net profit (rep./act.)	190	202	220	244	276
Net profit (adj.)	190	202	220	244	276
EPS (sen)	26.1	27.7	30.3	33.6	38.0
PE (x)	19.3	18.1	16.6	15.0	13.3
P/B (x)	7.4	5.9	4.8	3.9	3.3
EV/EBITDA (x)	12.9	11.9	11.3	9.9	8.6
Dividend yield (%)	1.6	1.9	2.0	2.3	2.5
Net margin (%)	25.8	21.7	21.0	19.8	18.4
Net debt/(cash) to equity (%)	(15.8)	(22.4)	(21.7)	(17.1)	(15.4)
Interest cover (x)	111.1	171.9	n.a.	n.a.	n.a.
ROE (%)	44.7	36.2	31.8	28.8	27.1
Consensus net profit	-	-	228	263	297
UOBKH/Consensus (x)	-	-	0.97	0.93	0.93

Source: Hartalega Holdings, Bloomberg, UOB Kay Hian

## SELL

(Maintained)

### Company Update

Share Price	RM5.03
Target Price	RM4.05
Upside	-19.5%
(Previous TP	RM3.58)

### Company Description

Rubber gloves manufacturer.

### Stock Data

GICS sector	Health Care
Bloomberg ticker:	HART MK
Shares issued (m):	732.2
Market cap (RMm):	3,683.2
Market cap (US\$m):	1,204.6
3-mth avg daily t'over (US\$m):	0.4

### Price Performance (%)

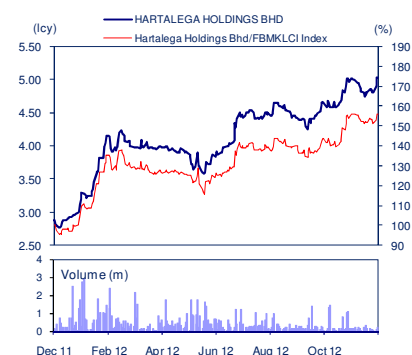
52-week high/low					RM5.03/RM2.77
1mth	3mth	6mth	1yr	YTD	
1.4	13.5	30.6	75.9	72.3	

### Major Shareholders

	%
Hartalega Industries Sdn Bhd	50.6
Budi Tenggara Sdn Bhd	5.0

FY13 NAV/Share (RM)	1.05
FY13 Net Cash/Share (RM)	0.23

### Price Chart



Source: Bloomberg

### Analysts

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### Stock Impact

- **NBR price likely to be at lower end of the scale...** The nitrile butadiene (NBR) price has been on a declining trend since Apr 12 and continued to ease to US\$1,320/tonne in Nov 12. Based on industry checks, we understand that NBR price is likely to continue to trend downward as there will be ample supply in the market, stemming from growing petrochemical plants amid soft global commodity prices. Hence, we have factored in lower NBR price assumption of RM4.50/kg from RM5.00/kg.
- **Mushrooming supply of nitrile glove suppresses margins...** Nitrile gloves capacity expansion is not only seen among the domestic producers but also the regional producers - especially from Thailand and Indonesia. We expect the local industry to raise production capacity of nitrile gloves by 40-46%, which well exceeds demand growth - global demand for nitrile gloves growth is seen at 15-20%. Burgeoning supply in the market will inevitably spark pricing pressure and pressure margin. We maintain our view that Hartalega's EBIT margin, which started to decline in FY11 (see RHS chart), will gradually contract to about 23-26% (from current 29.8% vs its peak of 33% in FY11) in FY13-15F.
- **Slowing nitrile gloves growth.** The ratio of the global demand for rubber and nitrile gloves is approximately 57:43 based on the Malaysia's 2011 export figures. Demand for nitrile gloves has been on a decelerating rate as the biggest nitrile glove importer, the US, is tipping into a saturation point. The slowdown is not adequately compensated by demand pick-up at the European market, where nitrile gloves usage is mostly concentrated in the UK and Germany.
- **Our forecasts have considered some flexibility in switching to natural rubber glove production.** Favourable supply-demand dynamics of natural glove production could eventually endow natural gloves with superior margins (nitrile gloves still provide slightly higher profit/unit at this juncture), and may force Hartalega to convert some of its nitrile facility to produce natural rubber gloves. However, the margin-gap threshold may still be far away, considering that Hartalega's natural latex glove production cost could be significantly higher than its peers' like Top Glove.
- **Major capex plans from FY14.** Meanwhile, we understand that the RM1.5b NGC will be funded by RM100m bank borrowings (for land purchase), proceeds from the conversion of warrants (expiring Mar 15) and internally generated cashflow. Hartalega will incur higher capex moving forward (about RM200m p.a. vs historical RM60m-85m p.a.). Hartalega's current net cash position is at RM148m or RM0.20/share.

### Earnings Revision/Risk

- We have tweaked our FY13-15F earnings forecasts upwards by 4-11% after imputing lower NBR cost assumption to RM4.50/kg (previously RM5.00/kg) alongside with lower ASP assumption to address our concern over the expected pricing pressure within the nitrile gloves segment.

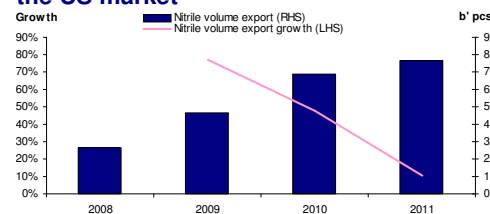
### Valuation/Recommendation

- **Maintain SELL, but raise our target price to RM4.05** (previously RM3.58) based on 12x 2014F PE (based on fully diluted EPS), which is close to 1SD above its historical mean PE. Our PE target for Hartalega is deservedly at a discount to our target PE for Top Glove given the latter is more well exposed to latex gloves (which faces more favourable supply-demand dynamics).

### Share Price Catalyst

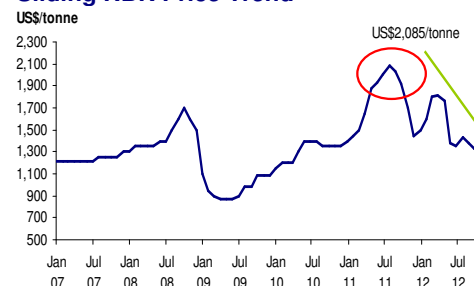
- Downside catalysts to the share price include a) potential price competition within the nitrile glove segment which will squeeze earnings margins and b) overcapacity in the nitrile glove market.

### Decelerating export volume growth rate in the US market



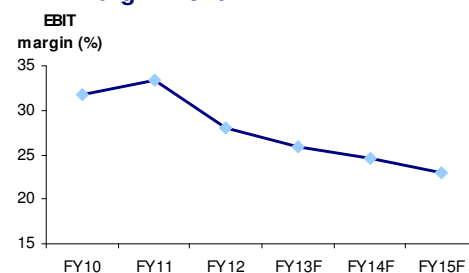
Source: Malaysia Rubber Export Promotional Council (MREPC)

### Sliding NBR Price Trend



Source: Hartalega

### EBIT Margin Trend



Source: Hartalega, UOB Kay Hian

### Nitrile Glove Installed Capacity Expansion In The Industry

Company	2013
Current installed capacity in 2012*	29.2
Supermax	5.2
Hartalega #	3.1
TopGlove	3.3
Kossan	1.0
Others	1.0
Total new installed capacity	13.6
Total by 2013*	42.8

\*Estimated industry installed capacity

# Installed production capacity expansion incorporates part of FY14 NGC expansion plan

Source: Various sources, UOB Kay Hian

### Key Assumption

	FY13F	FY14F	FY15F
Sales volume growth	16%	18%	22%
Utilisation rate	80%	82%	83%
ASP (RM' 000' pcs)	110	110	110
NBR price (RM/kg)	4.50	4.50	4.50

Source: UOB Kay Hian

**Profit & Loss**

Year to 31 Mar (RMm)	2012	2013F	2014F	2015F
<b>Net turnover</b>	<b>931</b>	<b>1,046</b>	<b>1,233</b>	<b>1,501</b>
EBITDA	299	313	358	413
Deprec. & amort.	38	43	56	71
EBIT	260	271	302	342
Net interest income/(expense)	(2)	4	4	3
<b>Pre-tax profit</b>	<b>259</b>	<b>275</b>	<b>305</b>	<b>345</b>
Tax	(57)	(55)	(61)	(69)
<b>Net profit</b>	<b>202</b>	<b>220</b>	<b>244</b>	<b>276</b>
Net profit (adj.)	202	220	244	276

**Balance Sheet**

Year to 31 Mar (RMm)	2012	2013F	2014F	2015F
Other LT assets	380	487	647	783
Cash/ST investment	163	191	283	295
Other current assets	209	198	226	276
<b>Total assets</b>	<b>752</b>	<b>876</b>	<b>1,156</b>	<b>1,354</b>
ST debt	13	13	113	113
Other current liabilities	67	47	65	80
LT debt	12	12	12	12
Other LT liabilities	40	40	40	40
Shareholders' equity	620	765	927	1,110
Minority interest	1	0	0	0
<b>Total liabilities &amp; equity</b>	<b>752</b>	<b>876</b>	<b>1,156</b>	<b>1,354</b>

**Cash Flow**

Year to 31 Mar (RMm)	2012	2013F	2014F	2015F
<b>Operating</b>	<b>201</b>	<b>252</b>	<b>275</b>	<b>305</b>
Pre-tax profit	259	275	305	345
Tax	(49)	(55)	(61)	(69)
Deprec. & amort.	38	43	56	71
Working capital changes	(25)	(6)	(22)	(39)
Other operating cashflows	(22)	(4)	(4)	(3)
<b>Investing</b>	<b>(60)</b>	<b>(150)</b>	<b>(200)</b>	<b>(200)</b>
Capex (growth)	(35)	(150)	(200)	(200)
Investments	0	0	0	0
Proceeds from sale of assets	0	0	0	0
Others	(25)	0	0	0
<b>Financing</b>	<b>(95)</b>	<b>(74)</b>	<b>18</b>	<b>(93)</b>
Dividend payments	(87)	(74)	(82)	(93)
Issue of shares	0	0	0	0
Proceeds from borrowings	0	0	100	0
Loan repayment	(14)	0	0	0
Others/interest paid	7	0	0	0
<b>Net cash inflow (outflow)</b>	<b>46</b>	<b>28</b>	<b>92</b>	<b>12</b>
<b>Beginning cash &amp; cash equivalent</b>	<b>117</b>	<b>163</b>	<b>191</b>	<b>283</b>
Changes due to forex impact	0	0	0	0
<b>Ending cash &amp; cash equivalent</b>	<b>163</b>	<b>191</b>	<b>283</b>	<b>295</b>

**Key Metrics**

Year to 31 Mar (%)	2012	2013F	2014F	2015F
<b>Profitability</b>				
EBITDA margin	32.1	30.0	29.0	27.5
Pre-tax margin	27.8	26.3	24.8	23.0
Net margin	21.7	21.0	19.8	18.4
ROA	29.2	27.0	24.0	22.0
ROE	36.2	31.8	28.8	27.1
<b>Growth</b>				
Turnover	26.7	12.3	17.9	21.7
EBITDA	8.9	4.9	14.2	15.4
Pre-tax profit	6.5	6.4	11.0	13.0
Net profit	6.3	9.1	11.0	13.0
Net profit (adj.)	6.3	9.1	11.0	13.0
EPS	6.3	9.1	11.0	13.0
<b>Leverage</b>				
Debt to total capital	3.8	3.1	11.9	10.1
Debt to equity	4.0	3.2	13.4	11.2
Net debt/(cash) to equity	(22.4)	(21.7)	(17.1)	(15.4)
Interest cover (x)	171.9	n.a.	n.a.	n.a.

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