

Sector Focus

Rubber Gloves

Malaysia Equity Research PP 17582/11/2012 (031102)

19 Dec 2012

Navigating cost pressures

- Demand for gloves remains resilient but higher wages and gas prices could cap earnings growth
- Expect margins to be flat in 2013 due to expansion of nitrile glove capacities
- We see value in Kossan at current valuation (upgrade to BUY; TP RM3.90)

Key challenges in 2013 – higher wages and gas prices. We expect labor costs to spike up in 1H 2013 following the implementation of minimum wage rule in Jan 2013 and gas prices could rise after the General Election. This could cap earnings upside despite low latex prices and strong volume growth.

Expect margins to be flat in 2013. We expect margins to be pressured by the robust expansion of nitrile gloves capacities. Top Glove, Supermax, Hartalega and Kossan are expected to add a total of 14bn pieces (+18% y-o-y) in 2013. Hartalega has pricing advantage over peers given its stronghold in nitrile gloves, and if it decides to price down its products to protect or expand market share, it would need to content with lower margins over the longer term. There has not been any margin compression as a result of pricing competition so far. In fact, margins had improved with sales volume picking up steadily since 3Q11. We expect Top Glove's and Kossan's margins to be flat in 2013 given that they had risen to their normalised levels (11-12%).

Strong YTD gains reflect lower latex prices and stronger volume growth. Top Glove and Hartalega's share prices gained 14% and 72% YTD, reflecting earnings and margin recovery arising from lower raw material prices and stronger volume growth. We believe Top Glove and Hartalega's current valuations (+0.5SD and +2SD of their historical means) have priced in the positives and reiterate our HOLD ratings.

Upgrade Kossan to BUY. We raised TP to RM3.90, pegged to 10.5x FY13 EPS. Kossan offers 19% ROE and 2-year (2012-2014) earnings CAGR of 17% (vs sector's 17% and 12%, respectively) while current valuation remains cheap at 9x PE (vs 11x sector average). Its YTD share price performance (+4%) is still lagging peers'. We believe stronger earnings traction from new nitrile and surgical capacities could re-rate the stock.

KLCI :1,648.58

Analyst

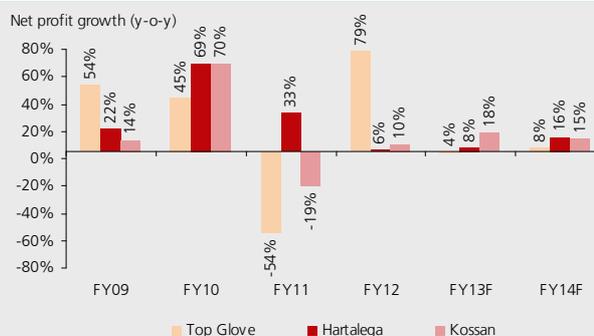
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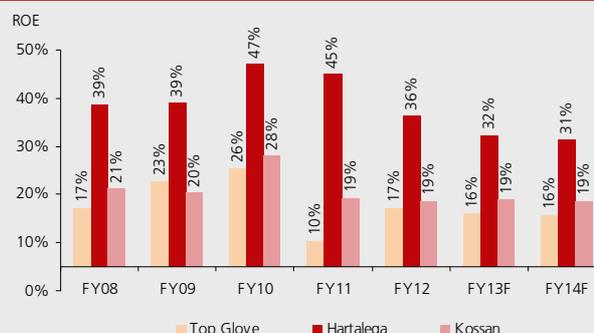
	Price	Mkt Cap	Target Price	Performance (%)		Rating
	RM	US\$m	RM	3 mth	12 mth	
Top Glove	5.65	1,143	5.40	9.9	27.3	HOLD
Hartalega Holdings	4.91	1,175	4.70	11.6	75.0	HOLD
Kossan Rubber	3.29	344	3.90	8.6	7.9	BUY

Source: DBS Vickers

Moderate earnings growth in FY13



ROE trend



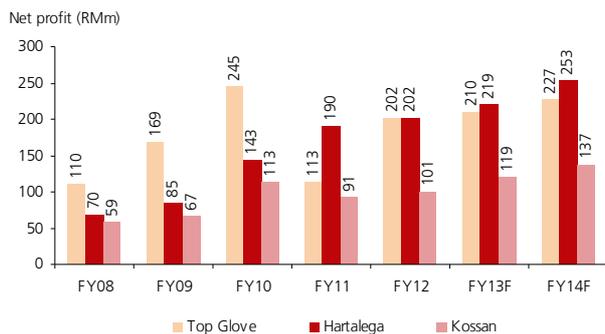
Source: Companies, DBS Vickers

Outlook for 2013

A) Moderate earnings growth

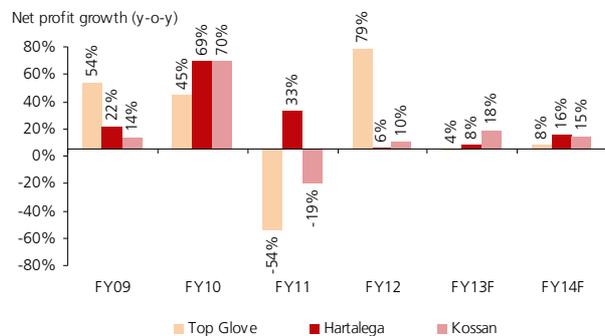
Costs pressure to cap earnings growth. We expect labor costs to spike up in 1H 2013 with the implementation of minimum wage rule in Jan-13. Meanwhile, gas prices could rise after the 13th General Election as the government had previously announced a scheduled increase in gas prices to match market prices. We expect Top Glove's net profit to grow at a modest 4%/8% in FY13/14F (FYE Aug) after a strong rebound in FY12 (+79% y-o-y) driven by recovering glove demand and lower latex prices. Its FY12 net profit was also lifted by a lower effective tax rate (14%) which will not be sustainable - we assumed 23% effective tax rate for FY13/14F. Hartalega's earnings growth should be more exciting at 16% in FY14F (FYE Mar) with the full commissioning of Factory 6. Kossan's earnings growth should chug along at 10%/18% in FY12/13F (FYE Dec).

Net profit trends



Source: Companies, DBS Vickers
Kossan's FY12 net profit is forecast

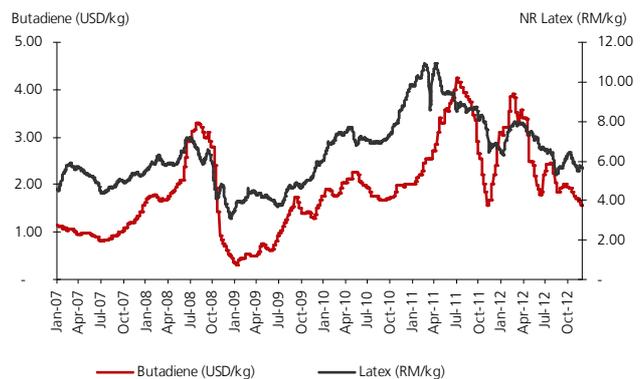
Net profit growth trends



Source: Companies, DBS Vickers
Kossan's FY12 net profit growth is forecast

Raw material prices remain low. We expect the low natural rubber (NR) latex prices to boost earnings but higher wages and potentially higher gas costs could cap earnings upside. Average latex prices fell 25% y-o-y (from RM RM8.95 per kg in 2011 to RM6.65 per kg in 2012) and most rubber gloves manufacturers enjoyed higher profits and margins in 2012 as a result of this.

Raw material prices trend



Source: Bloomberg, DBS Vickers

Higher labor costs effective 1 Jan 2013. The private sector in Peninsula Malaysia will reset its employees' monthly wage to a minimum of RM900. We expect labor costs to spike up in 1H2013 and dampen earnings. Assuming no change in ASPs (i.e. the additional labor costs are not passed on to customers), the glove producers under our coverage would incur additional RM10m-39m in labor costs, which would depress FY13 earnings by 5-19% (see table below). Our sensitivity analysis shows that Top Glove would be the most affected, and Hartalega the least affected, partly due to the size of their respective workforce.

Minimum wage sensitivity analysis (RM900 per month)

	Workforce (no. of staff)	% affected by minimum wage	Wage % to total production costs	(Based on RM900) Additional salary costs (RMm)	Impact on salary	Impact on profit
Top Glove	10,900	70%	9%	39	+22%	-19%
Kossan	5,000	80%	8%	18	+17%	-13%
Hartalega	2,900	75%	8%	10	+17%	-5%

Source: Companies, DBS Vickers

Automation and cost pass through to cushion minimum wage impact. The overall impact will not be as severe because glove manufacturers are taking pre-emptive measures to reduce reliance on manual labor by enhancing automation at production lines. The government has also provided some flexibility where some allowances or fixed cash payments are allowed to be absorbed in the calculation for minimum wage. Furthermore, glove manufacturers have the flexibility to pass on the higher wages to customers. Hence, the minimum wage impact should be neutralised over time.

Automation to overcome labor shortage and higher wages.

Top Glove has embarked on automation initiatives since 2H2012, with new factories (Factory 22 onwards) being equipped with robotic arms for gloves stripping, and it is also automating its packaging process. Management expects automation to reduce factory staff by 30-40%, and they will be redeployed to new factories. It will take time for the benefits of automation to be fully realized.

Scheduled increase in gas prices may resume. Energy costs account for 8-11% of glove makers' total production costs. Natural gas accounts for 60-70% and biomass and electricity 30-40%. Effective Jun-11, the government had raised gas price to RM16.07 per mmbtu (+7%) from RM15 per mmbtu, and there will be 8-19% increase in gas price every 6 months until 2015. So far, there was only one round of increase (i.e. in Jul-11) as election talks had stalled subsequent hikes. The government may resume the scheduled gas price hikes after the general election (by 1H2013).

B) Capacity expansion geared towards nitrile gloves

Robust demand for nitrile gloves leads to more capacity expansion. Demand for nitrile gloves continues to outpace NR gloves, and manufacturers continue to gear up nitrile gloves production capabilities. We expect the top four glove manufacturers (Top Glove, Supermax, Hartalega and Kossan) in Malaysia to add a total of 14bn pieces (+18% y-o-y) of nitrile gloves capacity by end 2013.

No industry glut but expect pricing competition. Production lines are usually commissioned progressively, and hence, there should not be any sudden supply glut in the industry. However, we expect some pricing competition going forward given that all glove producers will be motivated to sell their capacities once their production lines are built.

New expansion is geared towards nitrile gloves

Capacity (bn pcs)	2012	New capacities	2013	y-o-y growth
Top Glove	40.0	4.8*	44.8	12%
Supermax	17.8	5.4*	23.1	30%
Hartalega	10.0	3.5*	13.5	33%
Kossan	13.3	0.7^	14.0	5%
Total	81.1	14.3	95.4	18%

Source: Companies;

* nitrile gloves ^ surgical gloves

Top Glove: Capacity expansion schedule

	Production lines	Capacity (bn pcs)	Target completion
Current	458	40.0	
Expansion plan:			
F18 (Banting) –nitrile	16	1.5	Apr 2013
F25 (Klang) – nitrile	20	1.8	Jun 2013
F23 (Ipoh) - nitrile	16	1.5	Aug 2013
Total	510	44.8	

Source: Company

Supermax: Capacity expansion schedule

	Production lines	Capacity (bn pcs)	Target completion
Current	157	17.8	
Expansion plan:			
Lot 6058 - nitrile	16	2.1	Sep 2013
Lot 6059 - nitrile	24	3.2	Jul 2013
Total	197	23.1	

Source: Company

Hartalega: Capacity expansion schedule

	Production lines	Capacity (bn pcs)	Target completion
Current	45	10.0	
Expansion plan:			
Factory 6 - nitrile	10	3.5	Jul 2013
Total	55	13.5	

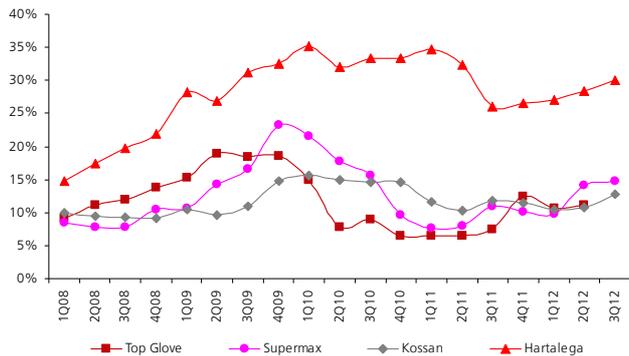
Source: Company

C) Flat margins

Pricing competition could pressure nitrile glove margins. We expect nitrile gloves margins to be under pressure with additional nitrile capacities the industry. Currently, Hartalega has pricing advantage over peers given its stronghold in higher margin nitrile gloves. Should Hartalega choose to price down ASP to protect and expand market share, it would need to content with lower margins over the longer term.

Margins had been improving this year. So far, we have not seen any margin compression as a result of pricing competition. In fact, margins had improved since 3Q11 with sales volume picking up steadily after inventories were run down to minimum levels in 1H2011. Distributors and stockists kept minimum stock during that period as ASPs were driven up by high raw material costs – NR latex and butadiene prices rose to record highs of RM10.90/kg and USD4.30/kg, respectively.

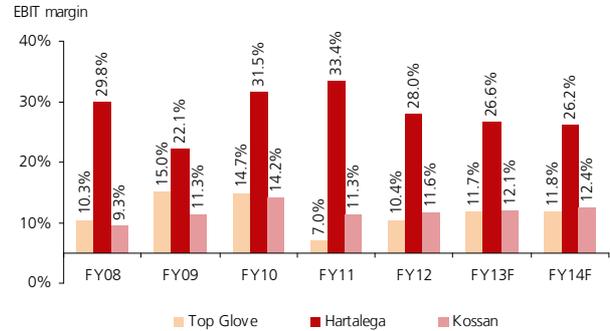
EBIT margins trends (quarterly)



Source: Companies, DBS Vickers

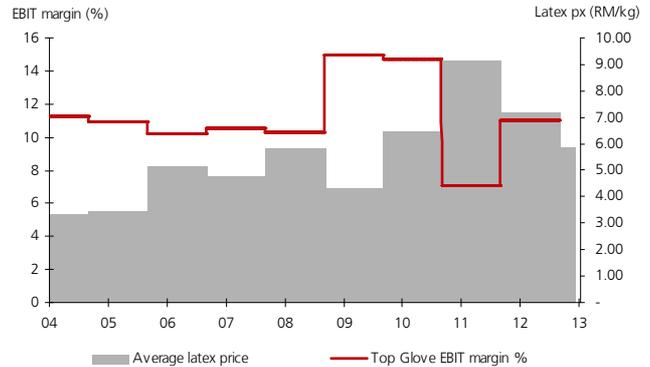
Expect margins to be flat in 2013; EBIT margins had risen to normalised levels. We expect Top Glove’s and Kossan’s margins to be flat or at best to improve by 1 ppt given that current EBIT margins are close to their normalise levels of 11-12%. Historically, Top Glove had delivered 10-11% EBIT margins when average latex prices were at RM5.00-RM6.00 per kg. The exceptionally high EBIT margins (15%) registered in FY09-10 were not sustainable as they were led by the H1N1 outbreak, and the subsequent dip to 6% in FY11 was due to massive de-stocking post-H1N1 and a surge in NR latex prices. Meanwhile, we forecast slight margin pressure at Hartalega amid higher competition in the nitrile segment.

EBIT Margin trends



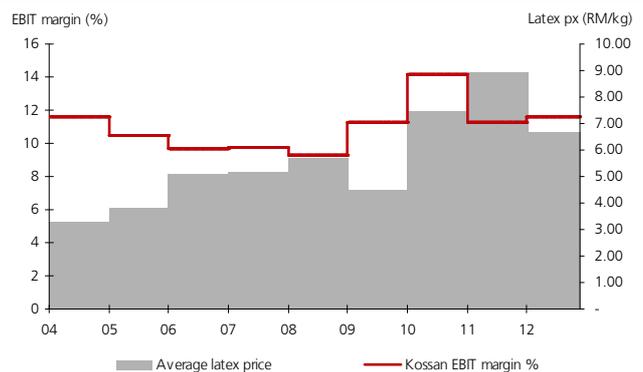
Source: Companies, DBS Vickers
Kossan’s FY12 EBIT margin is forecast

Top Glove margin trend vs NR latex price



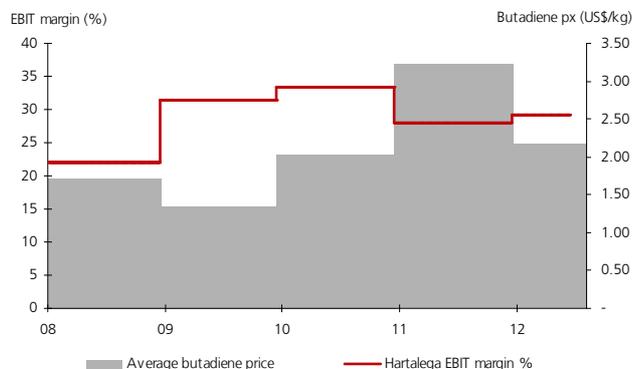
Source: Bloomberg, DBS Vickers

Kossan margin trend vs NR latex price



Source: Bloomberg, DBS Vickers

Hartalega margin trend vs butadiene price



Source: Bloomberg, DBS Vickers

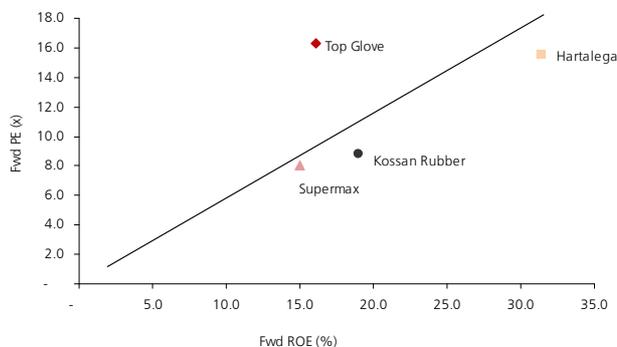
Valuations

Top Glove; Maintain HOLD, RM5.40 TP is pegged to 15.5x CY13 EPS. Current valuation at 16x forward PE already reflects Top Glove's earnings and margin recovery. A potential re-rating catalyst is improving efficiency from the automation of the production process, which should enhance operating margins. Foreign shareholding is lower at 32% (highest was about 35%).

Hartalega; Maintain HOLD; RM4.70 TP is pegged to 15.0x CY13 fully diluted EPS. The stock has re-rated to 16x forward PE (from 10x) and has priced in Hartalega's strong fundamentals - highest ROE and operating margins in the sector. A re-rating catalyst is stronger earnings traction from Factory 6 which is expected to be fully commissioned by Jul 2013. Foreign shareholding has risen to 14.4% (less than 10% previously).

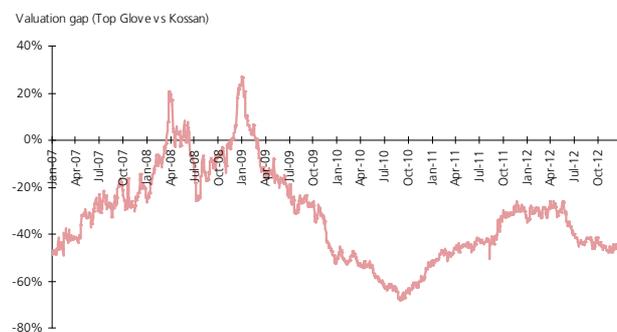
Kossan; upgrade to BUY; TP raised to RM3.90, pegged to 10.5x FY13 EPS which is equivalent to +1SD of its 10-year historical mean. We like Kossan for its compelling valuation (currently trading close to 9x FY13 EPS). It has the most attractive ROE-PE matrix, but YTD share price performance (+4%) is still lagging peers' (Top Glove +14%; Hartalega +72%). Kossan offers 19% ROE and 2-year (2012-2014) earnings CAGR of 17% (vs sector's 17% and 12%, respectively) while current valuation remains cheap at 9x PE (vs 11x sector average). A re-rating catalyst is stronger earnings traction from the newly commissioned nitrile glove lines (1.5-1.8bn pieces) and the commencement of surgical glove production (650m pieces) in 2013. One of the concerns for Kossan is low liquidity as average daily volume traded in 2012 is only about 200k shares vs Top Glove (1m) and Hartalega (440k).

Kossan has the most attractive ROE-PE matrix



Source: Bloomberg, Companies, DBS Vickers

Valuation gap between Kossan and Top Glove has widen



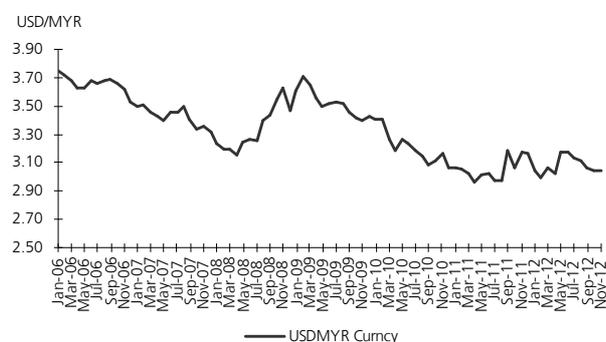
Source: Bloomberg, DBS Vickers

YTD share price performance



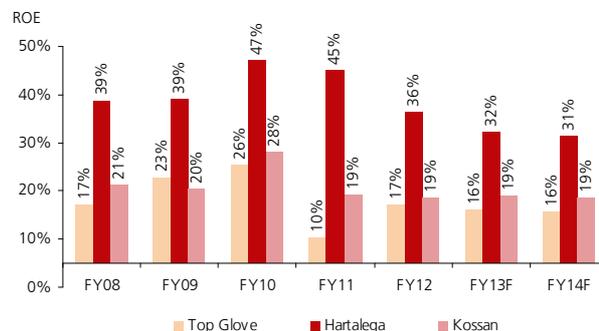
Source: Bloomberg, DBS Vickers

USD/MYR Currency



Source: Bloomberg, Companies, DBS Vickers

ROE trends



Peer comparison

Company	Share Price (RM)	Target Price (RM)	Rating	Market Cap (US\$m)	PE (x) CY11	PE (x) CY12	PE (x) CY13	P/BV (x)	Div Yield (%)	ROE (%)
Top Glove	5.65	5.40	HOLD	1,144	24.4	17.0	16.2	2.6	3.2	16.1
Hartalega	4.91	4.70	HOLD	1,176	16.3	16.5	15.7	4.9	3.1	31.4
Supermax	1.95	NA	NR	434	10.4	9.1	8.0	1.5	2.6	15.0
Kossan Rubber	3.29	3.90	BUY	344	11.5	10.5	8.8	1.8	2.4	19.0
Latexx Partners	2.10	NA	NR	153	13.1	9.5	8.1	1.9	1.9	14.0
Adventa	1.93	NA	NR	96	41.4	14.3	11.9	na	2.6	10.9
Simple Average					19.5	12.8	11.4	2.5	2.6	17.7

Prices as of 17 Dec 2012

NA (not applicable); NR (not rated)

Source: Bloomberg, DBS Vickers

Stock Profiles

Sector Focus

Kossan Rubber Industries

Bloomberg: KRI MK | Reuters: KRIB.KL

BUY RM3.29 KLCI : 1,648.58

(Upgrade from Hold)

Price Target : 12-Month RM 3.90 (Prev RM 3.35)

Potential Catalyst: Stronger growth from new capacities

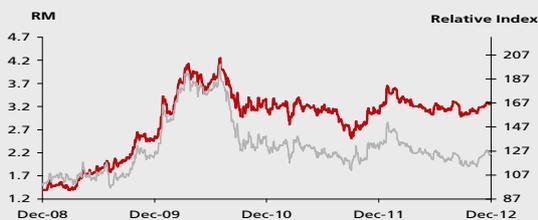
DBSV vs Consensus: In line with consensus

Analyst

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Price Relative



— Kossan Rubber Industries (LHS) — Relative KLCI INDEX (RHS)

Forecasts and Valuation

FY Dec (RM m)	2011A	2012F	2013F	2014F
Turnover	1,092	1,200	1,348	1,497
EBITDA	163	184	212	239
Pre-tax Profit	116	132	156	179
Net Profit	91	101	119	137
Net Pft (Pre Ex.)	91	101	119	137
EPS (sen)	28.6	31.5	37.3	42.8
EPS Pre Ex. (sen)	28.6	31.5	37.3	42.8
EPS Gth (%)	(19)	10	18	15
EPS Gth Pre Ex (%)	(19)	10	18	15
Diluted EPS (sen)	28.6	31.5	37.3	42.8
Net DPS (sen)	6.2	6.8	8.0	9.2
BV Per Share (sen)	156.0	181.4	211.8	246.5
PE (X)	11.5	10.5	8.8	7.7
PE Pre Ex. (X)	11.5	10.5	8.8	7.7
P/Cash Flow (X)	12.5	6.2	7.1	6.2
EV/EBITDA (X)	7.1	5.8	4.6	3.7
Net Div Yield (%)	1.9	2.1	2.4	2.8
P/Book Value (X)	2.1	1.8	1.6	1.3
Net Debt/Equity (X)	0.2	CASH	CASH	CASH
ROAE (%)	19.3	18.7	19.0	18.7

Earnings Rev (%) :	0.0	0.0	0.0
Consensus EPS (sen) :	32.7	37.1	41.8
Other Broker Recs :	B: 14	S: 0	H: 2

ICB Industry : Health Care

ICB Sector: Health Care Equipment & Servic

Principal Business: Latex examination gloves, nitrile gloves and technical rubber products manufacturer

Source of all data: Company, DBS Vickers, Bloomberg

Sector laggard

- **Upgrade to Buy, raised TP to RM3.90; one of the cheapest glove stocks at 9x PE**
- **Most attractive ROE-PE matrix in the sector**
- **Stronger earnings traction from new nitrile and surgical capacities could re-rate the stock**

Upgrade to Buy; raised TP to RM3.90. Current valuation at 9x FY13 EPS implies Kossan is the cheapest rubber glove stock in our universe. It offers the most attractive ROE-PE matrix, but YTD share price performance (+4%) is still lagging peers' (Top Glove +14%; Hartalega +72%). There could be stronger earnings traction from the newly commissioned nitrile glove lines (1.5-1.8bn pieces) and the commencement of surgical glove production (650m pieces) in 2013. We raised TP to RM3.90, pegged to 10.5x FY13 EPS which is equivalent to +1SD of its 10-year historical mean.

Most attractive ROE-PE matrix. Kossan offers 19% ROE and 2-year (2012-2014) earnings CAGR of 17% (vs sector's 17% and 12%, respectively) while current valuation remains cheap at 9x PE (vs 11x sector average). Although we expect Kossan's margins to be flat in 2013 because they have normalised to c.11%, improving efficiency arising from further automation of the production process could enhance operating margins going forward.

Key challenges – higher wages and gas prices. We expect labor costs to spike up in 1H 2013 with the implementation of minimum wage rule in Jan 2013 and gas prices could rise after the General Election. This could cap earnings upside despite low latex prices and strong volume growth. The other key concern for Kossan is low liquidity as average daily volume traded in 2012 is only about 200k shares vs Top Glove (1m) and Hartalega (440k).

At A Glance

Issued Capital (m shrs)	320
Mkt. Cap (RMm/US\$m)	1,052 / 344
Major Shareholders	
Kossan Holdings (%)	51.9
Kumpulan Wang Persaraan	7.6
Invesco Hong Kong Limited	5.0
Free Float (%)	48.1
Avg. Daily Vol.('000)	267

Kossan Rubber Industries

Income Statement (RM m)

FY Dec	2011A	2012F	2013F	2014F
Turnover	1,092	1,200	1,348	1,497
Cost of Goods Sold	(972)	(1,064)	(1,188)	(1,314)
Gross Profit	120	136	160	183
Other Opng (Exp)/Inc	3	3	3	3
Operating Profit	124	139	163	186
Other Non Opg (Exp)/Inc	0	0	0	0
Associates & JV Inc	0	0	0	0
Net Interest (Exp)/Inc	(7)	(7)	(7)	(7)
Exceptional Gain/(Loss)	0	0	0	0
Pre-tax Profit	116	132	156	179
Tax	(23)	(30)	(36)	(41)
Minority Interest	(2)	(1)	(1)	(1)
Preference Dividend	0	0	0	0
Net Profit	91	101	119	137
Net Profit before Except.	91	101	119	137
EBITDA	163	184	212	239
Sales Gth (%)	4.3	9.9	12.3	11.0
EBITDA Gth (%)	(10.6)	12.4	15.4	13.0
Opg Profit Gth (%)	(16.9)	12.7	17.0	14.2
Net Profit Gth (%)	(19.4)	10.1	18.3	14.8
Effective Tax Rate (%)	19.9	23.0	23.0	23.0

Cash Flow Statement (RM m)

FY Dec	2011A	2012F	2013F	2014F
Pre-Tax Profit	116	132	156	179
Dep. & Amort.	40	44	49	53
Tax Paid	(22)	(8)	(30)	(36)
Assoc. & JV Inc/(loss)	0	0	0	0
Chg in Wkg.Cap.	(48)	0	(26)	(26)
Other Operating CF	(2)	0	0	0
Net Operating CF	84	169	149	171
Capital Exp.(net)	(60)	(45)	(45)	(45)
Other Invts.(net)	(11)	0	0	0
Invts in Assoc. & JV	0	0	0	0
Div from Assoc & JV	0	0	0	0
Other Investing CF	0	0	0	0
Net Investing CF	(71)	(45)	(45)	(45)
Div Paid	(35)	(20)	(22)	(26)
Chg in Gross Debt	(11)	(10)	0	0
Capital Issues	0	0	0	0
Other Financing CF	2	0	0	0
Net Financing CF	(45)	(30)	(22)	(26)
Currency Adjustments	(6)	0	0	0
Chg in Cash	(38)	94	82	100

Quarterly / Interim Income Statement (RM m)

FY Dec	4Q2011	1Q2012	2Q2012	3Q2012
Turnover	282	289	305	323
Cost of Goods Sold	(250)	(260)	(273)	(282)
Gross Profit	31	30	32	41
Other Oper. (Exp)/Inc	1	0	1	1
Operating Profit	32	30	33	42
Other Non Opg (Exp)/Inc	0	0	0	0
Associates & JV Inc	0	0	0	0
Net Interest (Exp)/Inc	(2)	(2)	(2)	(1)
Exceptional Gain/(Loss)	0	0	0	0
Pre-tax Profit	30	29	31	40
Tax	(6)	(6)	(7)	(10)
Minority Interest	0	(1)	0	(1)
Net Profit	24	22	24	29
Net profit bef Except.	24	22	24	29
EBITDA	32	30	33	42
Sales Gth (%)	1.1	2.8	5.3	5.9
EBITDA Gth (%)	(2.3)	(5.9)	7.8	27.2
Opg Profit Gth (%)	(2.3)	(5.9)	7.8	27.2
Net Profit Gth (%)	0.9	(7.9)	7.6	23.7
Gross Margins (%)	11.2	10.3	10.4	12.7
Opg Profit Margins (%)	11.4	10.5	10.7	12.9
Net Profit Margins (%)	8.5	7.6	7.8	9.1

Balance Sheet (RM m)

FY Dec	2011A	2012F	2013F	2014F
Net Fixed Assets	434	435	431	422
Invts in Associates & JVs	0	0	0	0
Other LT Assets	5	5	5	5
Cash & ST Invts	52	146	228	328
Inventory	164	144	161	179
Debtors	149	215	242	268
Other Current Assets	9	9	9	9
Total Assets	812	955	1,076	1,211
ST Debt	137	137	137	137
Other Current Liab	108	179	201	224
LT Debt	17	7	7	7
Other LT Liabilities	42	42	42	42
Shareholder's Equity	499	580	677	788
Minority Interests	10	11	12	13
Total Cap. & Liab.	812	955	1,076	1,211
Non-Cash Wkg. Capital	213	190	210	231
Net Cash/(Debt)	(102)	3	85	184

Rates & Ratio

FY Dec	2011A	2012F	2013F	2014F
Gross Margins (%)	11.0	11.3	11.8	12.2
Opg Profit Margin (%)	11.3	11.6	12.1	12.4
Net Profit Margin (%)	8.4	8.4	8.8	9.1
ROAE (%)	19.3	18.7	19.0	18.7
ROA (%)	11.5	11.4	11.7	12.0
ROCE (%)	14.7	14.5	15.2	15.4
Div Payout Ratio (%)	21.6	21.6	21.6	21.6
Net Interest Cover (x)	16.6	19.1	24.0	27.4
Asset Turnover (x)	1.4	1.4	1.3	1.3
Debtors Turn (avg days)	48.9	55.3	61.9	62.2
Creditors Turn (avg days)	44.7	44.5	50.3	50.5
Inventory Turn (avg days)	56.6	55.2	49.0	49.2
Current Ratio (x)	1.5	1.6	1.9	2.2
Quick Ratio (x)	0.8	1.1	1.4	1.7
Net Debt/Equity (X)	0.2	CASH	CASH	CASH
Net Debt/Equity ex MI (X)	0.2	CASH	CASH	CASH
Capex to Debt (%)	38.8	31.3	31.3	31.3
Z-Score (X)	4.7	4.4	4.5	3.7
N. Cash/(Debt)PS (sen)	(31.8)	0.8	26.5	57.7
Opg CFPS (sen)	41.1	52.8	54.6	61.5
Free CFPS (sen)	7.6	38.8	32.4	39.3

Segmental Breakdown / Key Assumptions

FY Dec	2011A	2012F	2013F	2014F
Key Assumptions				
Capacity (bil pcs)	11.5	12.7	14.3	15.9
Utilization Rates (%)	90.0	90.0	90.0	90.0

Source: Company, DBS Vickers

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