

Rubber Gloves

Neutral
(maintained)

Mixed bag of gloves

We maintain Neutral on the rubber gloves sector. Overall demand for rubber gloves is resilient as higher sales volume of nitrile gloves more than offset the flat to lower sales volume of latex gloves. However, re-rating catalysts for the sector are scarce. Two stocks under our coverage appear fully-valued, as they trade at mid-to-high teens PER as compared to their pedestrian earnings growth. Our only Buy call is Kossan Rubber Industries due to its undemanding valuation and a product mix consisting of less natural rubber gloves, of which is sensitive to the latex price movement.

Key earnings drivers

- **Natural latex price to taper off post wintering months but expected to remain high.** Latex price appears to trend downwards post wintering season. However, over the medium term, latex prices may remain high due to the Thai government's intervention to support rubber prices. Based on the International Rubber Study Group (IRSG) in December 2011, demand for natural rubber is projected to gain 4.6% to 11.5m MT compared to a production increase of 5.1% to 11.4m MT.
- **ASP move in tandem with raw material price.** We believe a glut and hence a price war in the nitrile segment is less likely at least in the medium term due to resilient demand. However, the shift in demand to nitrile leading to falling sales volume could lead to a glut and ultimately a price war in the rubber glove segment.
- **Demand for gloves still intact, moving towards nitrile gloves.** Overall demand is expected to continue to be led by NR gloves but SR gloves has consistently taking market share away from the former.
- **Stronger Ringgit negative for glove makers.** Since sales are in USD, an appreciating Ringgit against the USD will lead to less receipt in revenue for glove makers.
- **High energy and labour costs going forward.** Looking ahead, we believe rubber glove players may face higher production costs emanating from high energy prices as well as the newly announced minimum wage policy.

Recommendation and valuations

- **Maintain Neutral on the sector.**
- We like **Kossan Rubber Industries** due to: (i) its undemanding valuations. Kossan is trading at 9x FY12 EPS compared to Top Glove's 22x FY12 EPS. (ii) The company is moving up the value chain by offering higher-margin surgical and clean room gloves; and (iii) a product mix consist of less natural rubber glove which is sensitive to movements in latex price. Maintain BUY with TP RM4.02 based on 11x FY12 EPS, in line with its historical average.
- **Top Glove.** Since our downgrade in early Jan 2012, the stock fell 18% to RM4.29/share before recovering to current level but still 10% lower. Top Glove's earnings growth would average 13% in FY12-14 albeit a rich PE. It is trading at 21x FY12 EPS (17% above historical average of 18x) while its peers are trading at a single digit or low teens. We are forecasting a slower growth due to lower-than-expected sales volume and a product mix skewed towards natural rubber (80% latex) which has lower margins than nitrile. Maintain SELL with TP RM4.00 based on 18x CY12 EPS, in line with its historical average.
- We like **Hartalega** because of: (i) its "highly automated production processes" model is moving from 'good' to 'great' as they have better margins (compared to peers), solid improvement in production capacity and reduction in costs; (ii) offers superior quality nitrile gloves through product innovation; and (iii) a booming nitrile segment. Currently trades at 13.4x CY12 and 12.2x CY13 EPS, compared to average net profit growth of 8%. Maintain HOLD with TP RM7.82 based on 13x CY12 EPS of 60.2 sen, 18% above its historical average due to its superior margins.

Stocks under coverage

Company	Bloomberg Ticker	Call	TP (RM)
Kossan	KRI MK	Buy	4.02
Top Glove	TOPG MK	Sell	4.00
Hartalega	HART MK	Hold	7.82

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FINANCIAL SNAPSHOT OF FINANCIAL AND VALUATION METRICS

Figure 1 : Sector comparison

Stock	Bloomberg Code	Call	Target Price	Last Price	Market Cap	Adj EPS		EPS Growth		P/E		P/BV		ROE		Net Div Yield	
						FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
			RM	RMI	RMm	sen	sen	%	%	x	x	x	x	%	%	%	%
Top Glove	TOPG MK	Sell	4.00	4.69	2,901	21.4	23.7	16.8	10.9	21.9	19.8	2.4	2.3	11.5	12.0	2.6	3.0
Hartalega	HART MK	Hold	7.83	7.80	2,850	56.9	61.3	8.9	7.7	13.7	12.7	4.7	3.9	34.1	30.5	3.3	3.5
Kossan Rubber	KRI MK	Buy	4.02	3.25	1,039	36.6	42.4	27.9	15.9	8.9	7.7	1.7	1.4	19.5	18.9	3.1	3.1
Sector total								17.9	11.5	14.8	13.4	2.9	2.5	21.7	20.5	3.0	3.2

Source: ECM Libra, Bloomberg

Share price date: 30 Apr 2012

Figure 2 : Share price performance

Company / Index	Last week	Month to date		YTD	30-day	90-day	180-day	365-day
		%	%					
TOPG MK	0.5	-1.6	-11.4	-5.5	-13.5	7.5	-14.6	
HART MK	0.4	-0.6	35.3	-0.6	21.5	42.9	37.2	
KRI MK	0.0	-4.5	-1.5	-3.9	-8.3	15.1	0.0	
FBMKLCI	-0.5	-0.8	3.5	-0.1	4.0	8.6	4.0	

Source: Bloomberg



KEY EARNINGS DRIVERS

Natural latex price to taper off post wintering months but remain high. Latex price appears to trend downwards post wintering season. Over the last two weeks, latex price has retraced from a year high of RM7.95/kg to RM7.44/kg (-6%) as at 26 April 2012 (YTD +16%). In anticipation of normalized latex production post wintering period (between Feb and May), latex price has tapered off. Over the medium term, latex price may remain high due to the Thai government's intervention to support rubber prices. Based on industry checks, natural latex price is expected to hover between RM6.50/kg and RM7.50/kg in 2H12. According to the International Rubber Study Group (IRSG) in Dec 2011, demand for natural rubber is projected to gain 4.6% to 11.5m MT compared to production increase of 5.1% to 11.4m MT. Meanwhile, the Association of Natural Rubber Producing Countries stated that supply from key producing countries will expand less than forecast for this year. As such, the shortage is expected to push up prices of natural rubber or at least remain high. Rubber glove players, natural rubber (NR) and synthetic (SR) managed to remain profitable in 2011, the period of consistently high latex prices. The flattish or marginal decline in quarterly earnings at that time was largely due to higher ASPs which led to lower sales volume.

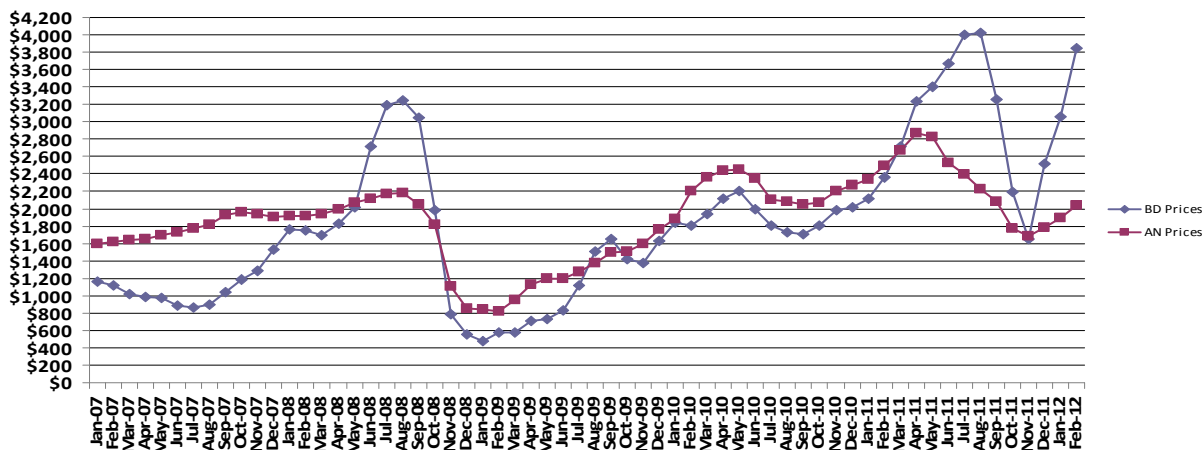
Figure 3 : Natural latex price appears to taper off post wintering season



Source: ECM Libra, Bloomberg

NBR tracks crude oil price. We believe nitrile butadiene rubber (NBR) price has risen substantially in the recent months (see Figure 4) due to high oil price (by-products of ethylene are feedstock for NBR) and tight supply. Generally, NBR price moves in tandem with crude oil. Note that crude oil price has started tapering off its high and hence we expect NBR price to follow suit.

Figure 4 : Natural price of butadiene (BD) and acrylonitrile (AN) – butadiene comprises about 67% of nitrile and the balance from acrylonitrile



Source: ECM Libra, various



ASPs move in tandem with raw material price. Typically, ASP for natural rubber gloves would rise in tandem with increase in input raw material costs. Conversely, when feedstock cost falls, rubber glove players generally pass on the cost savings to their customers via lowering ASPs. This is a mutual agreement between the producers and their customers. We believe a glut and hence a price war in the nitrile segment is less likely at least in the medium term due to the resilient demand. In fact, the ASPs per pair of nitrile gloves rose 9.0% in 2011 to RM0.23. However, the shift in demand to nitrile which caused a decline in sales volume could lead to a glut and ultimately a price war in the latex glove segment. As such, latex glove producers are more susceptible to any sharp increases in ASPs compared to nitrile glove makers. Current ASPs for nitrile is USD\$32.20 per 1,000 pieces compared to natural latex glove at USD\$31.50 per 1,000 pieces.

Figure 5 : ASP in 2010 and 2011 - ASPs per pair of nitrile glove rose 9.0% in 2011 to RM0.23.

Average selling prices of gloves in 2010 and 2011	2010	2011	% change
NR Powdered surgical	0.51	0.59	15.2
NR Powdered-free surgical	1.03	1.11	7.5
SR powdered surgical	0.62	0.75	19.6
SR powder-free surgical	1.54	1.63	5.7
NR powdered examination	0.14	0.19	37.0
NR powder-free examination	0.20	0.24	19.2
SR powdered examination	0.21	0.23	9.0
SR powder-free examination	0.20	0.22	10.4
NR clean room	0.48	0.51	5.0
SR clean room	0.45	0.40	(11.2)

[^]price in RM per pair

NR – natural rubber, SR – synthetic rubber (>90% nitrile)

Source: Malaysian Rubber Export Promotion Council (MREPC)

Demand for gloves still intact, moving towards nitrile gloves. We believe the average 10% demand p.a. for rubber gloves over the next few years is still intact. Overall demand is expected to continue to be led by NR gloves but SR gloves has consistently been taking up the former's market share. Over the last two years, Malaysia export of rubber gloves, NR and SR has deteriorated. In 2011, Malaysia's total export of gloves was 35.6 billion pairs, 4.5% lower y-o-y. However in terms of sales value, exports rose 9.8% y-o-y to RM9.4bn largely due to higher ASPs. Whilst latex-based gloves or NR are still dominant (as a percentage to overall exports of rubber gloves) in Malaysia, the trend is moving towards SR. This is evident from NR:SR sales value ratio of 69:31 in 2010 to 61:39 in 2011, and sales volume ratio of 69:31 in 2010 compared to 58:42 in 2011. The quantity of NR gloves exported in 2011 fell 20% to 20.5 billion pairs y-o-y due to high cost of input raw material. Meanwhile, exports of SR gloves increased 29% in 2011 to 14.8 billion pairs of gloves. Amplifying the demand growth for nitrile gloves are its superior quality and lightness (vs natural rubber gloves) as well as high latex price which has narrowed the ASP gap between latex and nitrile-based, making the latter cheaper.



Figure 6 : Declining trend in latex but nitrile gloves gaining further momentum

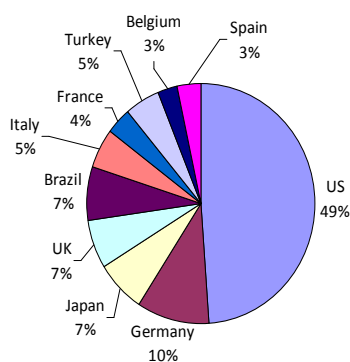
Destination	2009 (million pairs)		2010 (million pairs)		2011 (million pairs)		2011 vs 2010		2010 vs 2009	
	NR	SR	NR	SR	NR	SR	% NR chg	% SR chg	% NR chg	% SR chg
EU	8,042	1,513	8,526	2,449	6,351	4,437	(26)	81	6	62
USA	6,321	4,668	5,778	6,891	3,640	7,620	(37)	11	(9)	48
South America	3,151	72	3,054	90	2,868	173	(6)	92	(3)	25
East Asia	1,952	440	1,866	997	1,610	1,315	(14)	32	(4)	127
Non-EU countries	1,294	40	1,488	79	1,292	134	(13)	70	15	98
West Asia	1,050	35	1,080	55	1,152	86	7	56	3	57
Africa	810	16	954	33	958	73	0	121	18	106
ASEAN	580	51	628	65	560	178	(11)	174	8	27
Oceania	743	104	628	209	562	236	(11)	13	(15)	101
North America	929	330	959	556	821	470	(14)	(15)	3	68
South Asia	190	2	273	6	467	22	71	267	44	200
CIS Countries	311	14	314	30	289	46	(8)	53	1	114
Other	1	19	2	35	4	32	100	(9)	100	84
Total	25,374	7,304	25,550	11,495	20,574	14,822	(19)	29	1	57

Source: MREPC

Natural and synthetic rubber gloves exports in 2011 explained. In 2011, Malaysia exported 14.8 billion pairs of synthetic rubber (SR) gloves or an increase of 28% and 103% from 2010 and 2009 respectively. Correspondingly, in terms of value, SR exports rose 42% and 106% in 2010 and 2009 respectively, to RM3.7bn in 2011. The solid growth is largely due to nitrile gloves. Exports of nitrile gloves in 2011 was 14.6 billion pairs (RM3.4bn), making up 93.7% of total value of SR gloves exported. However, we note that exports of NR gloves have deteriorated for the second consecutive year in 2011. In the same year, exports of NR gloves fell to 20.6 billion pairs (-19.2% y-o-y) valued at RM5.7bn (-3.4% y-o-y). Malaysia's export of NR gloves in 2010 and 2009 are 25.5 billion (RM5.9bn) and 25.4 billion (RM5.4bn), respectively.

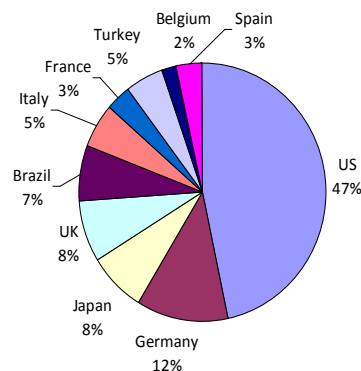
The US is the largest importer of Malaysian SR gloves where in 2011, the country imported 7.6 billion (RM1.9bn) SR gloves, a 10% increase from 2010 and 62% increase from 2009 exports. Conversely, exports of NR gloves during the year to the US was the lowest in 3 years at 3.6 billion pairs (RM1.2bn), down 38% and 43% from 2010 and 2009, respectively. The US remains the no. 1 market for rubber gloves (32%) in general but the EU (34%) has displaced US' no.1 (20%) position in NR as US is switching from NR to SR likely due to pricing and concerns of protein allergy.

Figure 7 : Top ten export destinations for rubber gloves in 2010



Source: ECM Libra, MREPC

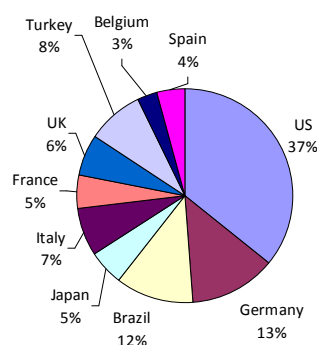
Figure 8 : Top ten export destinations for rubber gloves in 2011



Source: ECM Libra, MREPC

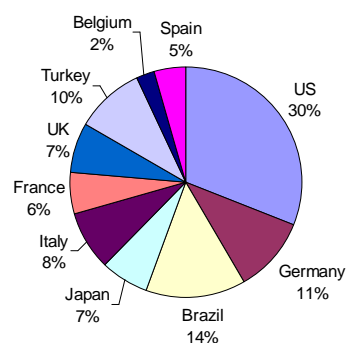


Figure 9 : Top ten export destinations for NR in 2010



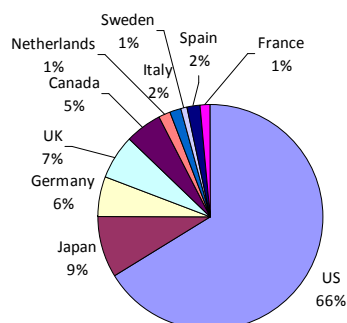
Source: ECM Libra, MREPC

Figure 10 : Top ten export destinations for NR in 2011



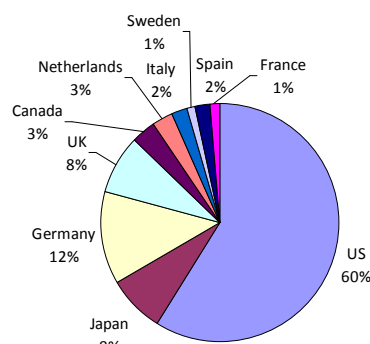
Source: ECM Libra, MREPC

Figure 11 : Top ten export destinations SR gloves in 2010



Source: ECM Libra, MREPC

Figure 12 : Top ten export destinations for SR gloves in 2011



Source: ECM Libra, MREPC

Figure 13 : Exports of rubber gloves by usage in 2010 and 2011

Type	2010		2011		Value chg (%)	Quantity chg (%)
	Value (RMm)	Quantity (million pairs)	Value (RMm)	Quantity (million pairs)		
Examination	6,245	32,939	6,673	30,766	6.9	(6.6)
Surgical	825	986	968	1,074	17.3	8.9
High Risk	219	616	216	413	(1.4)	(33.0)
Total medical gloves	7,289	34,541	7,857	32,253	7.8	(6.6)
Cleanroom	117	249	165	368	41.0	47.8
Household	512	417	609	398	18.9	(4.6)
Industrial	614	1,734	621	1,865	1.1	7.6
Food Grade	12	65	10	50	(16.7)	(23.1)
Others	26	66	159	470	511.5	612.1
Total non-medical gloves	1,281	2,530	1,564	3,151	22.1	24.5
Total	8,570	37,071	9,421	35,405	9.9	(4.5)

Source: MREPC



Stronger Ringgit negative for glove makers. Since sales are USD denominated, theoretically, an appreciating Ringgit against the dollar will lead to less receipt in revenue for glove makers. The Ringgit is currently hovering between RM3.00 and RM3.08/USD. *Ceteris paribus*, a 1% RM appreciation against USD will lead to 2-3% drop in net profit.

High energy and labour costs going forward. Looking ahead, we believe rubber glove players may face higher production costs emanating from high energy prices as well as the recently announced minimum wage policy. Effective Jun 2011, the government has raised gas price by 7% to RM16.07 per mmbtu from RM15 per mmbtu. There will be a subsequent 8-19% price increase every 6 months until 2015. However, the dateline for the last review in December 2011 has passed and yet to be effected. At the same time in 2011, the electricity tariff rate was raised by 8-10%. The hike in energy prices was expected, in line with the Government's subsidy reduction rationalization programme. Meanwhile, the just announced minimum wage policy is expected to hit Top Glove, Kossan Rubber and Hartalega's CY13 bottom line by 7-15% assuming no cost pass through and before restructuring the revised new wage scheme to incorporate some fixed allowances into the calculation of minimum wage. Given that manufacturers affected have 6 months grace period from gazette date, we believe rubber glove payers can gradually pass down the cost. For now we keep our earnings forecast unchanged. Additionally, any employers who fail to comply within the grace period could also apply for extension of the transition period. The policy will be reviewed once every two years.

RECOMMENDATION AND VALUATIONS

Maintain Neutral. Overall demand for rubber gloves is still resilient as higher sales volume of nitrile gloves more than offset the flat-to-lower sales volume of latex gloves. However, clear re-rating catalysts in the sector are scarce. Two stocks under our coverage appear fully-valued, trading at mid-to-high teens PER compared to their pedestrian earnings growth. We have a BUY call on Kossan Rubber Industries due to its undemanding valuation and a product mix of lesser NR gloves which is sensitive to movements in latex price.

Top Glove. Top Glove's earnings growth would average 13% in FY12-14 albeit a rich PE valuation. It is trading at 21x FY12 EPS (17% above its historical average of 18x) while its peers are trading at a single digit or low teens. We are forecasting a slower growth due to lower-than-expected sales volume and a product mix skewed towards NR (80% latex) which has lower margins compared to nitrile. Maintain SELL with TP of RM4.00 based on 18x CY12 EPS, in line with its historical average.

Kossan Rubber Industries. We like Kossan because of: (i) its undemanding valuations. Kossan is trading at 9x FY12 EPS compared to Top Glove's 22x FY12 EPS. (ii) The company is moving up the value chain by offering higher-margin surgical and clean room gloves; and (iii) a product mix which contains lesser NR gloves which is sensitive to movements in latex price. Maintain BUY with RM4.02 target price based on 11x FY12 EPS, in line with its historical average.

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DISCLOSURE & DISCLAIMER

Stock rating definitions

- | | |
|-------------|--|
| Strong buy | - High conviction buy with expected 12-month total return (including dividends) of 30% or more |
| Buy | - Expected 12-month total return of 15% or more |
| Hold | - Expected 12-month total return between -15% and 15% |
| Sell | - Expected 12-month total return of -15% or less |
| Trading buy | - Expected 6-month total return of 15% or more arising from positive newsflow. However, upside may not be sustainable. |

Sector rating definitions

- | | |
|-------------|--|
| Overweight | - Industry expected to outperform the market over the next 12 months |
| Neutral | - Industry expected to perform in-line with the market over the next 12 months |
| Underweight | - Industry expected to underperform the market over the next 12 months |

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