Hartalega Holdings

Head and shoulders above the rest

We are upgrading Hartalega Holdings (Hartalega) from a MARKET PERFORM rating to an OUTPERFORM. Our TP has been raised by 13% from RM5.12 to RM5.93 as we rolled forward our 12-month TP valuation from 15.0x CY13 EPS to 15.0x CY14 EPS. The 15x PER attached is at a 25% premium to our sector average 1-year forward PER target due to its superior margins and bigger market capitalisation compared to its peers. We like Hartalega for (i) its "highly automated production processes" model, (ii) the solid improvement in its production capacity and reduction in costs, leading it to achieve better margins compared to its peers; (iii) its superior quality nitrile gloves through product innovation and (iv) its positioning in a booming nitrile segment with a dominant market position.

Plant 6 to boost FY14 earnings. Plant 6 will have 10 production lines for nitrile gloves at 45,000 pieces/hour/line, 25% more than the current ones. This brings its production capacity in Plant 6 to 3.9b pieces p.a., which will increase total end-FY14 production capacity by 27% to 14b pieces, to be fully completed in mid-2013. To date, we understand that seven production lines have been commissioned. The remaining three lines are expected to contribute progressively starting from 4QFY13. The construction of the balance three will give it a total of 10 lines in Plant 6, which is expected to be fully completed in June 2013. For illustrative purposes, assuming a net margin of 20% (average net margin over the last eight quarters was 23%), an average selling price of RM95 per 1,000 pieces and a 85% sales utilisation rate, this new capacity will fetch a total net profit of RM66m or 26% of our FY14 forecast. We have factored in the contribution from this capacity expansion into our earnings forecasts.

Major expansion beyond FY14, NCG expected to start construction in Sep 2013. Recall that Hartalega is embarking on a massive capacity expansion consisting of 72 new production lines, which we believe will be largely for nitrile gloves. The expansion will cost RM1.9b and will be carried out in two phases over eight years between 2013 and 2021. We understand that the project is expected to commence in 2013 and to gradually start contributing in FY15. A total of eight lines or an estimated 10-12% increase in capacity to 15.4b pieces of gloves are expected to contribute to FY15 earnings with the first line expected to come on-stream in Aug 2014. This project will be undertaken by its wholly-owned subsidiary, Hartalega NGC Sdn Bhd. The acronym NGC refers to 'Next Generation Integrated Glove Manufacturing Complex'. Salient points of the project are: 1) the project will be located at a new site measuring 112 acres, (ii) new plants will be built with several dedicated buildings linked to each other. This includes Research & Development Centre, Learning and Development Centre, Renewable Energy plant (which we believe will run on Biomass), workers quarters and sports centre, (iii) the project will be spread over two phases over 4 years and will require 4,600 workers, (iv) the first phase is scheduled to commence in 2013-2017 comprising of 40 production lines (production capacity of 14b p.a.) and (v) the second phase is scheduled to begin in 2018-2021, comprising 32 production lines (production capacity of 14.5b p.a.). When completed, Hartalega's glove production capacity will more than double from 14.0b pieces (once plant 6 is fully commissioned by FY14) to a staggering 42.5b pieces p.a. in 2021. The new lines are expected to boost productivity by an average of 50% or 45,000 pieces/line/hour compared to an average of 30,000 currently. We have factored in RM200m capex p.a. in FY14 and FY15 earnings estimates.

Head and shoulder above the rest in terms of margins, efficiency and technology. Hartalega is constantly moving up the value chain via offering superior product innovation and automating its production processes. A case in point, Hartalega has been producing thinner and lighter nitrile gloves from 4.7g in 2005 to 3.7g in 2007 and currently, at 3.2g. Over the past few years, technological and automated processes which can be seen in its plants were (i) double former dipping line with touchscreen interface, (ii) automated mechanical stripping system (removing nitrile gloves of hand moulds) and (iii) glove puller and stacker system. Standing testimony to Hartalega's "highly automated production processes" model are (i) margins that are above its peers (Hartalega's pre-tax margins averaged 29% compared to its industry peers of 13% over the last two years), (ii) reduction in staff cost to 6.1% in FY12 from 14.4% in FY02 and (iii) an increase in production capacity from 8,000 pieces/line/hour in Plant 1 to currently 45,000 in Plant 6 thanks to its in-house technological and R&D capabilities. We believe further efficiency enhancements through automation in Plant 6 and the currently lighter gloves (raw material savings) are expected to mitigate the margin erosion going forward. Additionally, the cost per glove has improved from 7.7 sen/piece to 7.1 sen/piece over the last 12 months due to economies of scale and production efficiency.

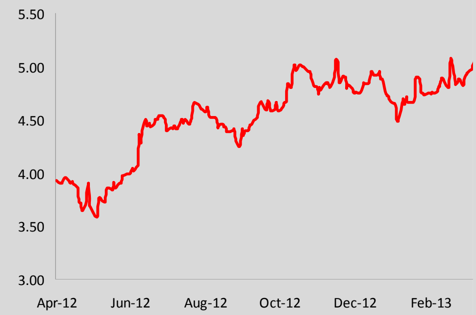
Demand for gloves still intact, nitrile gloves have consistently eaten into latex glove's market share. According to the Malaysian Rubber Export Promotion Council, in 2012, the total exports of rubber gloves, synthetic rubber (SR) and natural rubber (NR) rose 14.9% YoY led by the solid double digit volume growth from nitrile gloves and a rebound in the sales volume of latex gloves. Going forward, the overall demand for rubber gloves is expected to be resilient, led by NR gloves, although SR gloves, which had consistently been taking up the former's market share, will continue to show better growth prospects. This was evident from the lower NR:SR sales volume ratio of 69:31 in 2010 compared to 54:46 in 2012. This trend favours Hartalega as >90% of its product mix is nitrile.

OUTPERFORM ↑

Price: **RM5.25**

Target Price: **RM5.93** ↑

Share Price Performance



KLCI	1,713.46
YTD KLCI chg	1.5%
YTD stock price chg	10.5%

Stock Information

Bloomberg Ticker	HART MK Equity
Market Cap (RM m)	3,850.9
Issued shares	733.5
52-week range (H)	5.30
52-week range (L)	3.56
3-mth avg daily vol:	640,602
Free Float	44.5%
Beta	0.7

Major Shareholders

HARTALEGA INDUSTRIES SDN BHD	50.2%
BUDI TENGGARA	5.0%

Summary Earnings Table

FY Mar (RM'm)	2013E	2014E	2015E
Turnover	1164.1	1347.7	1592.6
EBIT	296.9	333.2	389.3
PBT	299.6	334.9	390.7
Net Profit (NP)	229.1	256.2	298.8
Consensus (NP)	229.4	264.1	296.0
Earnings Revision			
EPS (sen)	31.4	35.1	41.0
CY EPS (sen)	34.2	39.5	45.0
EPS growth (%)	13.8	11.8	16.6
NDPS (sen)	13.7	15.3	17.8
BVPS (RM)	1.0	1.2	1.5
PER	16.7	14.9	12.8
CY PER	15.3	13.3	11.7
PBV (x)	5.1	4.3	3.6
Net Gearing (x)	Net Cash	Net Cash	Net Cash
Dividend Yield (%)	2.6	2.9	3.4

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Income Statement

FY Mar (RM m)	2011A	2012A	2013E	2014E	2015E
Revenue	931.1	931.1	1164.1	1347.7	1592.6
EBITDA	288.2	288.2	326.0	370.6	438.0
Depreciation	-29.0	-29.0	-29.0	-37.4	-48.6
Operating Profit	259.2	259.2	296.9	333.2	389.3
Other Income	0.9	0.9	4.2	3.3	2.9
Interest Exp	-1.7	-1.7	-1.6	-1.6	-1.6
Associate	0.0	0.0	0.0	0.0	0.0
Exceptional Items	0.0	0.0	0.0	0.0	0.0
PBT	258.4	258.4	299.6	334.9	390.7
Taxation	-57.0	-57.0	-70.4	-78.7	-91.8
Minority Interest	-0.1	-0.1	-0.1	-0.1	-0.1
Net Profit	201.4	201.4	229.1	256.2	298.8
Core Net Profit	201.4	201.4	229.1	256.2	298.8

Balance Sheet

FY Mar (RM m)	2011A	2012A	2013E	2014E	2015E
Fixed Assets	370.3	370.3	441.2	603.8	755.2
Intangible Assets	0.0	0.0	0.0	0.0	0.0
Other FA	9.9	9.9	13.3	13.3	13.3
Inventories	97.5	97.5	102.4	118.6	140.1
Receivables	117.1	117.1	155.7	181.0	214.7
Other CA	0.1	0.1	0.0	0.0	0.0
Cash	163.2	163.2	204.3	159.4	140.7
Total Assets	758.1	758.1	917.0	1076.1	1264.1
Payables	60.4	60.4	90.6	104.8	123.9
ST Borrowings	12.6	12.6	12.6	12.6	12.6
Other ST Liability	12.5	12.5	11.7	11.7	11.7
LT Borrowings	12.1	12.1	12.1	12.1	12.1
Other LT Liability	40.5	40.5	40.5	40.5	40.5
Minorities Int.	0.6	0.6	0.6	0.7	0.8
Net Assets	**619.5**	**619.5**	**748.9**	**893.7**	**1062.5**
Share Capital	182.5	182.5	182.5	182.5	182.5
Reserves	437.0	437.0	566.4	711.1	879.9
Equity	**619.5**	**619.5**	**748.9**	**893.7**	**1062.5**

Cashflow Statement

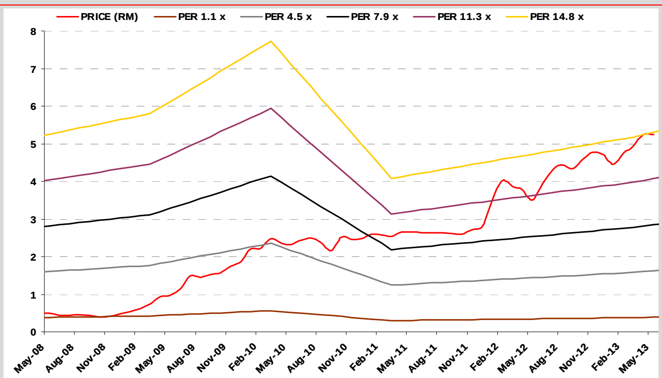
FY Dec (RM m)	2011A	2012A	2013E	2014E	2015E
Operating CF	200.3	200.3	240.5	266.5	311.3
Investing CF	(60.1)	(60.1)	(100.0)	(200.0)	(200.0)
Financing CF	(95.0)	(95.0)	(99.7)	(111.4)	(130.0)
Change In Cash	45.2	45.2	40.9	(44.9)	(18.6)
Free CF	164.9	164.9	140.5	66.5	111.3

Financial Data & Ratios

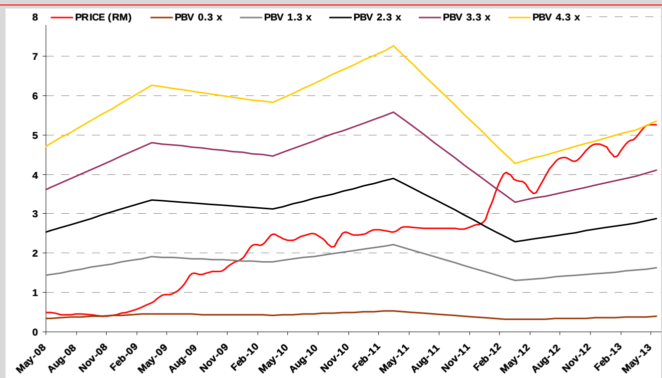
FY Mar (RM m)	2011A	2012A	2013E	2014E	2015E
Growth					
Turnover (%)	28.5%	26.7%	25.0%	15.8%	18.2%
EBITDA (%)	34.0%	7.6%	13.1%	13.7%	18.2%
Operating Profit (%)	34.9%	6.7%	14.5%	12.2%	16.8%
PBT (%)	36.5%	6.4%	15.9%	11.8%	16.6%
Core Net Profit (%)	33.0%	5.8%	13.8%	11.8%	16.6%
Profitability (%)					
EBITDA Margin	36.5%	31.0%	28.0%	27.5%	27.5%
Operating Margin	33.1%	27.8%	25.5%	24.7%	24.4%
PBT Margin	33.0%	27.8%	25.7%	24.9%	24.5%
Core Net Margin	25.9%	21.6%	19.7%	19.0%	18.8%
Effective Tax Rate	21.6%	23.0%	23.5%	23.5%	23.5%
ROA	30.0%	26.6%	25.0%	23.8%	23.6%
ROE	38.5%	32.5%	30.6%	28.7%	27.7%
DuPont Analysis					
Net Margin (%)	25.9%	21.6%	19.7%	19.0%	18.8%
Assets Turnover (x)	0.9	0.8	0.8	0.8	0.8
Leverage Factor (x)	1.3	1.2	1.2	1.2	1.2
ROE (%)	38.5%	32.5%	30.6%	28.7%	28.1%
Leverage					
Debt/Asset (x)	0.1	0.0	0.0	0.0	0.0
Debt/Equity (x)	0.1	0.0	0.0	0.0	0.0
Net Cash/(Debt)	Net Cash	Net Cash	Net Cash	Net Cash	Net Cash
Net Debt/Equity (x)	Net Cash	Net Cash	Net Cash	Net Cash	Net Cash
Valuations					
EPS (sen)	26.1	27.6	31.4	35.1	41.0
NDPS (sen)	21.0	10.8	13.7	15.3	17.8
NTA (RM)	0.7	0.8	1.0	1.2	1.5
PER (x)	20.1	19.0	16.7	14.9	12.8
Net Div. Yield (%)	4.0	2.0	2.6	2.9	3.4
P/NTA (x)	7.7	6.2	5.1	4.3	3.6
EV/EBITDA (x)	14.0	12.8	11.2	10.0	8.5

Source: Kenanga Research

Fwd PER Band



Fwd PBV Band



Source: Kenanga Research

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM : A particular stock's Expected Total Return is MORE than 10%
(An approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%)
MARKET PERFORM : A particular stock's Expected Total Return is WITHIN the range of 3% to 10%
UNDERPERFORM : A particular stock's Expected Total Return is LESS than 3%
(An approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate)

Sector Recommendations***

OVERWEIGHT : A particular sector's Expected Total Return is MORE than 10%
(An approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%)
NEUTRAL : A particular sector's Expected Total Return is WITHIN the range of 3% to 10%
UNDERWEIGHT : A particular sector's Expected Total Return is LESS than 3%
(An approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate)

***_**Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.**_

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