Malaysian Gloves

Sector outlook - NEUTRAL

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Malaysia
Healthcare

Stock: Hartalega
Ticker: HART MK
Mkt Cap: US$1.4bn
Rec: O-PF
TP: RM7.00 (from RM5.80)

Stock: Top Glove
Ticker: TOPG MK
Mkt Cap: US$1.2bn
Rec: U-PF
TP: RM6.50

The push and pull factors

Interest has come back to the Malaysian rubber glove sector due to the companies' USD exporter status as well as falling feedstock prices. However, manufacturers tend to pass on cost savings to their customers and Top Glove's recent results highlight the competitive pricing pressures in the latex segment. The demand outlook remains robust despite the high base effect of the previous year and there is always the potential for spikes due to the MERS and H7N9 outbreaks. Our relative preference in the sector is for Hartalega (O-PF) versus Top Glove (U-PF) and the recent share price correction presents a good opportunity to accumulate.

USD and commodity sensitivities

- The strengthening USD has sparked interest in the Malaysian glove sector given revenues are denominated in USD and demand is relatively inelastic.
- Top Glove is better geared to movements in currency given its cost base is denominated in ringgit while Hartalega's feedstock (butadiene) costs are in USD.
- Commodity prices (feedstock; making up c.50% of production costs) have been coming, benefiting manufacturers; however, most of the savings are passed on.

Demand outlook

- While the demand outlook remains favourable for synthetic gloves, the latex segment is currently facing headwinds from competitive ASPs.
- Top Glove's 3Q13 weak margins were a result of the competitive pricing of powder-free gloves vs. synthetic.
- Top Glove's volume growth forecast is 15-18% this year versus Hartalega at 20%.

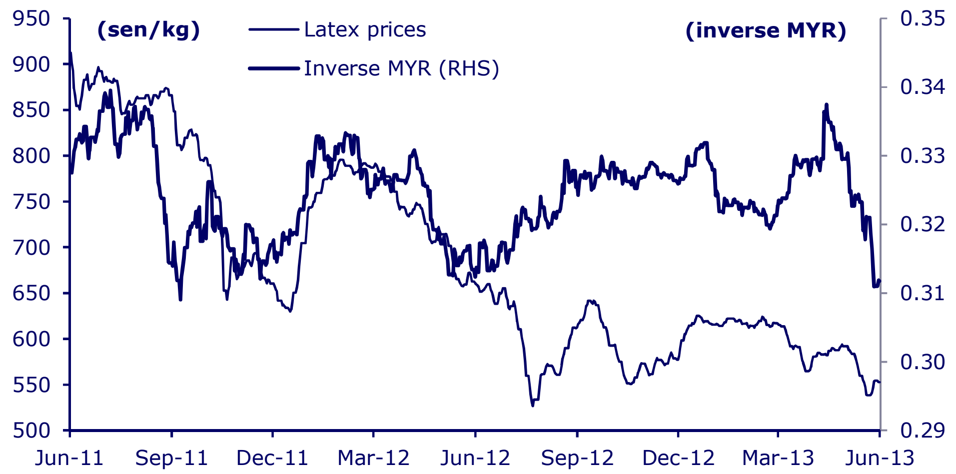
Capex adding up

- Top Glove is going through a heavy capex cycle with commitments for plant expansion, upstream assets as well as M&A.
- Hartalega on the other hand only has commitments for its NGC plant.
- Although both companies are net cash, Top Glove is looking to raise some debt to cover its capex requirements, hence allowing it to maintain its dividend policy.

Neutral – Positives priced in

- We remain neutral on the sector; although falling input costs, favourable currency movements and stable demand outlook are positive, these drivers appear priced in.
- We upgrade our T/P for Hartalega, our preferred sector exposure, to RM7.00 (from RM5.80) based on a higher target PE multiple of 18x and retain our O-PF rec.
- We maintain our U-PF and RM6.50TP on Top Glove in the wake of recent poor results which highlight the competitive pressures in the latex segment.

Feedstock prices and currency movements



Source: CLSA

The push and pull factors

Interest has returned to the glove sector as a safe haven given the glove manufacturers are USD exporters with their cost base in MYR and will benefit from the continued USD appreciation.

Recent spike in the USD given the capital flight from emerging markets

Figure 1

MYR/USD exchange rate

Source: CLSA

Commodity prices are heading south as well as we iterated in our previous report on ***Top Glove - BUY (Smit-ing our rubber forecast)*** with rubber prices now at the RM5.50 mark which is below our RM6.00 FY13 forecast.

This is a function of both the oversupply currently pervasive in the rubber market but also the fact that the Thai government is not continuing its program to support rubber prices.

Seeing a steady decline

Figure 2

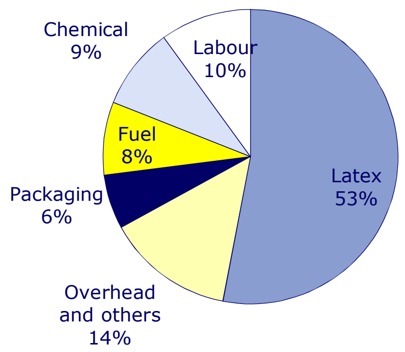
Rubber prices

Source: Bloomberg

Top Glove is much more geared to movements in the USD given that its feedstock costs (mostly latex) are denominated in MYR whilst Hartalega's feedstock costs (mostly butadiene) are denominated in USD providing a partial natural hedge against fluctuations in USD.

Figure 3

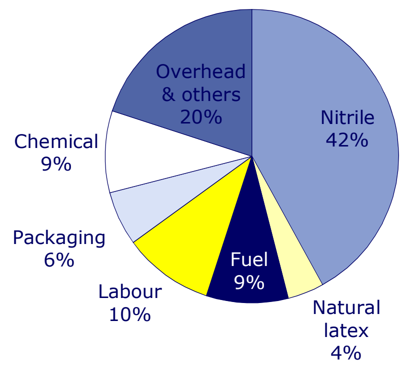
Top Glove: Operating cost breakdown



Source: Top Glove

Figure 4

Hartalega: Operating cost breakdown



Source: Hartalega

MYR depreciation is better for Top Glove

Therefore impact to current FY from a 1% depreciation in our MYR forecast would have a bigger impact on Top Glove as it would see a 6.2% increase in FY13CL net profits compared to Hartalega which would only see a 2.1% increase.

Top Glove hedges 1 month forward receivables using swaps

Top Glove employs a very vanilla hedging policy wherein it uses plain vanilla swaps to lock in its one-month forward USD receivables from its customers.

Demand outlook

Demand remains robust with volume growth of 15-20% expected

Due to the fact that both Top Glove and Hartalega's customers are mainly in the healthcare sector, demand for gloves continues to be robust. Top Glove is guiding for volume growth of 15-18% this year, driven by its fast-growing synthetic gloves segment, while Hartalega is guiding for volume growth of 20% given its focus on nitrile gloves.

Synthetic rubber remains the better growth prospects

Growth in the synthetic glove segment continues to be robust with most expecting growth rates of c. 20%YoY while growth in the latex segment is much slower at c. 6-8%YoY. 2012 saw a growth of 26%YoY in Malaysian exports of synthetic rubber gloves while natural rubber glove exports grew 7%YoY.

Top Glove remains very much a latex focused producer

Top Glove remains primarily a latex glove producer with 75% of volumes currently focused in this segment while Hartalega remains very much a synthetic glove focused producer. Top Glove is adding capacity to this segment with all of its capacity additions (c. 6.8bn pcs of additional production by April 2014) to be added to the synthetic gloves segment.

Ramping up capacity in the synthetic rubber segment

Figure 5

Top Glove: Production capacity

	No of prod lines	Capacity (bn pcs)	Completion
Current: 23 factories	470	41.1	
Expansion plan:			
F28 (Banting, Malaysia)	8	0.8	Jun-13
F25 (Klang, Malaysia) New	20	2	Aug 13
F27 (Lukut, Malaysia) Phase 2	8	0.8	Dec 13
F23 (Ipoh, Malaysia) Phase 2	16	1.6	Mar 14
F29 (Klang, Malaysia) New	16	1.6	Apr 14
Total expansion by Apr 2014	**68**	**6.8**	
Total @ Apr-14: 25 factories	**538**	**47.9**	

Source: CLSA, Top Glove

Competition in latex segment

Latex segment is seeing competition especially in powder-free segment

Top Glove's recent 3Q13 result release highlighted the competition in the latex segment due to falling ASPs particularly in the powder-free NR segment. The selling price for powder-free gloves is now US$26/1,000 gloves compared to synthetic gloves at US$28/1,000 gloves.

Continued drop in price for synthetic gloves pressuring latex gloves

The pressure on the ASPs for the powder-free gloves is due to the continued drop in the price of the more premium synthetic (nitrile) gloves which at US$28/1,000 gloves has fallen from US$31-32/1,000 gloves which is where ASPs were last year.

The reason for the stronger correction in the synthetic gloves is due to the correction in the feedstock costs while the weight of the gloves has also been reducing resulting in much less butadiene required per glove.

Feedstock costs for synthetic gloves have been depreciating

Figure 6

Butadiene prices

Source: Hartalega

Top Glove saw margins decline sharply due to competitive pricing in the latex segment

Figure 7

Top Glove: 3Q13 results snapshot

RMm	**3Q12**	**2Q13**	**3Q13**	**QoQ**	**YoY**
Revenue	603	576	604	5	0
Operating Expenses	(544)	(521)	(568)	9	4
Other Operating Income	5	6	7	23	46
Profit From Operations	**64**	**61**	**43**	**(30)**	**(33)**
Operating costs	522	495	541	9	4
EBITDA	81	82	63	(23)	(22)
Depreciation	17	21	21	(1)	18
Fx gains losses	5	5	(0)	(109)	(108)
Core EBITDA	**76**	**77**	**64**	**(17)**	**(16)**
Finance Costs	(0)	(0)	(0)	22	135
Share of Profits From Associate	0	0	1	555	1,009
Interest Income	0	0	0		
PBT	**64**	**61**	**43**	**(29)**	**(32)**
Taxation	(9)	(10)	(2)	(82)	(79)
Effective tax	*13.9%*	*16.4%*	*4.2%*		
PAT	**55**	**51**	**42**	**(19)**	**(24)**
Minority Interest	1	(1)	(1)	26	(223)
Net profit (RMm)	**54**	**50**	**42**	**(17)**	**(23)**
Margin					
Ebitda	13.4%	14.2%	10.5%		
Ebit	10.6%	10.6%	7.1%		
PBT	10.6%	10.7%	7.2%		
Net profit	8.9%	8.7%	6.9%		

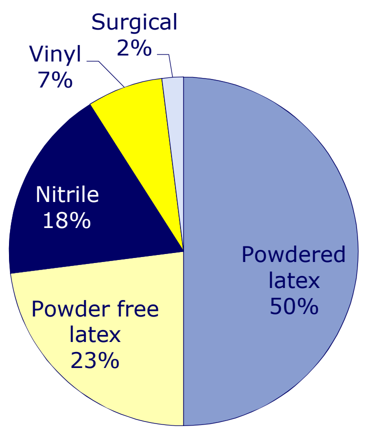
Source: CLSA, Top Glove

This is negative for Top Glove as evidenced by the recent quarter results which saw margins come off despite the strong volume growth of 17%YoY and the falling latex prices. The ASP reduction was much stronger resulting in poorer margins given Top Glove's powder-free gloves make up a quarter of the company's production volumes.

A quarter of Top Glove's production is powder-free gloves

Figure 8

Top Glove 3Q13 volume export



Source: Top Glove

Capex adding up

Heavy capex cycle due to capacity additions

Both glove companies are embarking on a heavy capex cycle. Hartalega is ramping up capacity with the commissioning of its next generation complex (NGC) which will quadruple its capacity over 4 years while Top Glove is also similarly adding capacity mainly in the nitrile segment.

Top Glove buying upstream assets, investment properties and M&A

However, Top Glove have also recently acquired a smaller glove manufacturer, GMP Medicare, as well as made an investment into property via the purchase of The Icon building in the city centre. They also have to spend on their recent foray upstream with the purchase of a rubber plantation.

Figure 9

Top Glove: Recent acquisitions

Date	Acquisition	Considerations (RMm)
25-Jun-12	PT Agro (plantation)	22.0
17-Jul 12	GMP Medicare	24.1
5-Mar 13	The Icon	12.2

Source: CLSA

Rubber plantation acquisition small but still puzzling

The acquisition of the rubber plantation remains puzzling, despite the small quantum of investment of RM450m spread out over 13 years, as Top Glove is seeking to grow its synthetic rubber side of the business while there remains a surplus of rubber in the market that is unlikely to reverse due to the surfeit of plantings by the Thai planters.

15-year capex plan being increased from RM3bn to RM3.8bn

Further, the acquisition of the Icon building now looks even worse in retrospect, as when they first acquired there were CG questions being raised, given the chairman has recently announced that they are increasing their 15-year factory capex plan to RM3.8bn from RM3.0bn.

Next 3 years going to see heavy capex

This means that the company is looking at RM300m in capex in FY13 and RM200-250m in FY14-15. This is up from RM150-200m per annum in capex that the company was projecting earlier.

FY13CL will see the company turn FCF negative

We are estimating FCF that the company will generate for FY13/14/15CL is RM292/315/368m so this year the company will turn FCF negative. This means that the company's cash pile is likely to start depleting given the company's dividend policy of a 40% payout ratio.

Net cash position but borrowings could be increased to support dividends

The company is still in a net cash position as at the end of 3Q13 (31-May-2013) but intends to drawdown on borrowings to maintain a healthy working capital position. Top Glove has cash on hand of RM106m versus borrowings of RM24.7m.

Hartalega much more comfortable position

Hartalega on the other hand is in a much better position as they have enough operating cash flows to cover their capex requirements of NGC. The company estimates capex to be RM250m in FY14 rising to RM300m in FY15 then will be steady at RM200-250m from FY16 onwards.

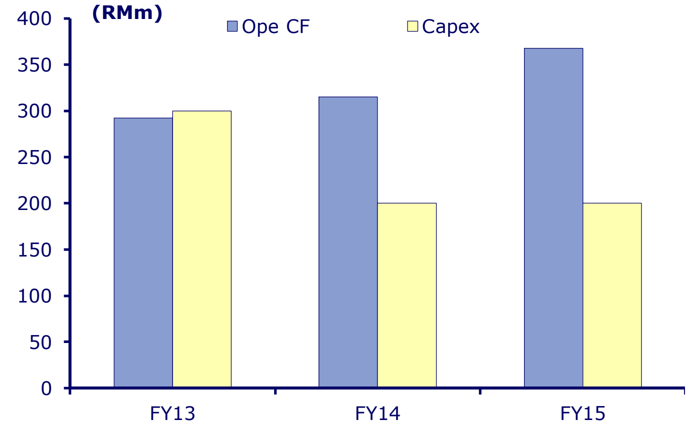
FCF positive and net cash despite capex plans

We estimate that the company will continue to be marginally FCF positive as we estimate FCFs to be RM281/323/347m for FY14/15/16CL. Hartalega is also in a net cash position as of FY3/13 with borrowings of only RM11m versus cash on hand of RM182m.

Hartalega has a dividend policy of 50% payout of net profits.

Figure 10

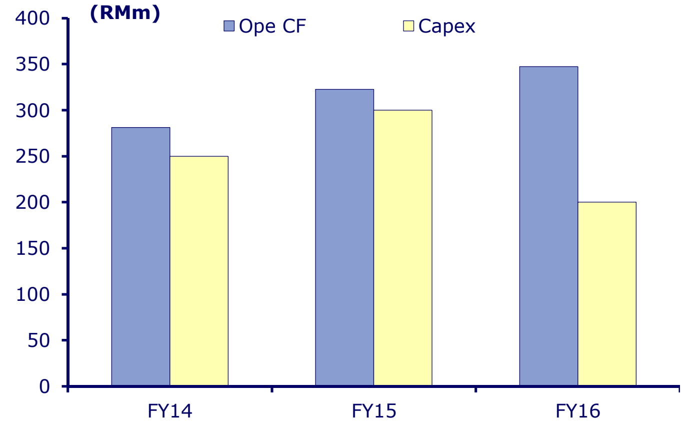
Top Glove: Ope CF vs Capex



Source: CLSA

Figure 11

Hartalega: Ope CF vs Capex



Source: CLSA

Stock picks

Neutral – drivers in sync but priced in

We remain Neutral on the sector as while all the drivers remain in sync, this looks very much price into valuations. Demand remains resilient as the end-users are in the healthcare sector while both commodity prices (input costs) and currency movements are in the manufacturers favour.

Recommend switch to Hartalega from Top Glove

We retain our positive O-PF rating on Hartalega and recommend a switch from Top Glove (U-PF) given concerns about competition in the latex segment. A further correction in Hartalega would be an opportunity to add to positions.

Increasing multiple for Top Glove

We are upgrading our TP for Hartalega to RM7.00 (from RM5.80) previously as we are ascribing a higher PE multiple of 18x which is at a 20% premium to Top Glove's 5-year average multiple of 15x.

Multiples have corrected from 2009 peaks – average of 15x

Figure 12

Top Glove: 5-year average PE multiple

Source: CLSA

Hartalega – more efficient, better margins and ROEs as well as synthetic focused

Our belief is that a higher multiple for Hartalega is justified given its product mix is skewed towards nitrile which is still the fastest growing segment and seeing less competition than the latex segment. Hartalega also remains a more efficient player than its peers by virtue of its more efficient processes and investments in R&D which garner it higher margins and superior ROEs of 33% versus the sector at 21%.

Figure 13

Hartalega: Summary valuations

Year to 31 March	12A	13A	14CL	15CL	16CL
Revenue (RMm)	931	1,032	1,196	1,326	1,569
Net profit (RMm)	201	235	264	289	320
EPS (sen)	27.7	32.2	34.5	37.9	44.0
CL/consensus (13) (EPS%)	-	-	100	100	102
EPS growth (% YoY)	5.7	16.6	7.1	9.6	16.3
PE (x)	22.2	19.1	17.8	16.2	14.0
Dividend yield (%)	2.0	2.4	2.7	2.9	3.3
FCF yield (%)	3.0	1.8	2.0	2.3	3.0
PB (x)	7.2	6.0	5.5	4.7	3.7
ROE (%)	36.1	34.3	32.1	29.7	28.1
Net debt/equity (%)	(22.3)	(15.0)	(9.4)	(6.0)	(3.9)

Source: CLSA

We retain our O-PF call on Hartalega following the stock's strong run-up since our last update on the company.

Trading at a premium given increasing size

Figure 14

Hartalega: 5-year average PE multiples

Source: CLSA

Hartalega is trading at a premium to historical averages given the company has grown in size and its current market cap is now larger than Top Glove's compared to when it listed back in 2008.

Top Glove an U-PF with unchanged TP

Our RM6.50TP and U-PF recommendation for Top Glove remains unchanged which is based on 16x PE which is a 10% premium to the company's 5-year average PE of 15x. While Top Glove is seeing the bigger benefit from movements in the currency which justifies the higher multiple, the recent poor results highlight the competitive pressures in the natural rubber segment and its onerous capex plans puts pressure on FCFs which may crimp dividend payments.

Figure 15

Top Glove: Summary

Year to 31 August	11A	12A	13CL	14CL	15CL
Revenue (RMm)	2,054	2,314	2,400	2,722	2,861
Net profit (RMm)	113	203	221	244	267
EPS (RM)	0.18	0.33	0.36	0.39	0.43
CL/consensus (20) (EPS%)	-	-	104	102	102
EPS growth (% YoY)	(55.9)	79.6	9.0	10.0	9.6
PE (x)	34.4	19.2	17.6	16.0	14.6
Dividend yield (%)	1.7	2.6	2.6	2.8	3.1
FCF yield (%)	0.8	3.1	(0.2)	3.0	4.3
PB (x)	3.5	3.1	2.8	2.6	2.3
ROE (%)	10.2	17.1	16.8	16.8	16.7
Net debt/equity (%)	(12.7)	(12.8)	(2.0)	(0.2)	(1.3)

Source: CLSA

Figure 16

Glove manufacturers peer comp

Name	BBG code	Mkt Cap	ADT	PE (x)		EPS Growth (%)		ROE (%)	Yield (%)	PB (x)
		(US$bil)	(US$m)	CY13	CY14	CY13	CY14	CY13	CY13	CY13
Top Glove	TOPG MK Equity	1.2	3.2	17.1	15.5	9.3	9.9	16.8	3.2	2.7
Hartalega	HART MK Equity	1.4	1.6	19.3	17.7	9.5	9.0	32.7	2.8	6.0
Ansell	ANN AU Equity	2.2	14.5	16.2	13.6	9.4	10.8	16.9	2.4	2.7
Supermax	SUCB MK Equity	0.4	2.3	9.3	8.1	15.0	14.6	14.8	3.1	1.3
Kossan	KRI MK Equity	0.5	1.1	11.6	10.1	22.6	14.2	18.8	2.4	2.1
		Wgt Avg		**16.3**	**14.4**	**10.9**	**10.7**	**20.8**	**2.7**	**3.4**

Source: CLSA, Bloomberg consensus estimates for SUCB and KRI

Top Glove and Hartalega are trading above the sector averages on a PE basis given its larger size and better liquidity. The smaller-cap glove names trade at a discount on a PE basis but Hartalega is currently trading at a premium to Top Glove given prospects for the company are brighter given its synthetic product focus.

Companies mentioned

Hartalega (HART MK - RM6.02 - OUTPERFORM)
Top Glove (TOPG MK - RM6.15 - UNDERPERFORM)

Key to CLSA investment rankings: BUY: Total return expected to exceed market return AND provide 20% or greater absolute return; **O-PF**: Total return expected to be greater than market return but less than 20% absolute return; **U-PF**: Total return expected to be less than market return but expected to provide a positive absolute return; **SELL**: Total return expected to be less than market return AND to provide a negative absolute return. For relative performance, we benchmark the 12-month total return (including dividends) for the stock against the 12-month forecast return (including dividends) for the local market where the stock is traded. We define stocks we expect to provide returns of 100% or higher including dividends within three years as "Double Baggers".