INTER-PACIFIC RESEARCH SDN BHD
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Industrial Products

31 Jan 2013

Hartalega Holdings Bhd

Initiating Coverage

BUY

Current Price	**RM 4.52**
Consensus Price	**RM 4.90**
Target Price	**RM 5.73**

Key Statistics

Bloomberg Ticker	HART MK
Masa Ticker / Stock Code	HARTA/5168
Shares Issued (m)	732.6
Market Capitalisation (RM'm)	3,311
52 Week Hi/Lo Price (RM)	5.10/3.48
Avg Trading Volume (3-mth)	249,310
Est Free Float (m)	329.67
YTD Returns (%)	29.5
Beta (x)	0.67

Major Shareholders (%)

Hartalega Industry Sdn Bhd	50.2
Puri Tenggara	5

1-Year Share Price Performance

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Growing by leaps and bounds

We are initiating coverage on Hartalega Holdings Bhd with a buy call and a target price of **RM5.73** (27% Upside). Established in 1988, Hartalega is a global market leader in nitrile rubber examination gloves. We like Hartalega for: 1) its high capacity growth over the next 8 years. 2) a strong profit margin that buffers profits during price wars 3) the recession-proof nature of its industry 4) its enviable position as the most efficient glove producer.

State of the art production facilities

The RM1.5b, 8-year investment in new production facilities (called "NGC") will see installed capacity grow more than four-fold by CY2021. We expect production to increase gradually from 11b to 43b pieces annually and the NGC project to contribute the minimum sales revenue of RM2.5b per annum upon completion. Next Generation Integrated Manufacturing Complex (NGC) will consist of a R&D centre, renewable energy complex, training and development centre, sports and recreational complex and workers' quarters.

Valuation and risks

We tag our valuation at a PE of 14x on FY14E EPS of 40.9sen. We forecast revenue will grow 10% and 42% and net earnings to grow 10% and 35% for FY13 and FY14 respectively. We are concerned over a looming nitrile glove supply glut that will lower the company's average selling price (ASP). However, we are confident it will have a marginal effect because of the cost savings with every new plant built.

Table 1 : Earnings Forecasts

FYE Dec	FY11	FY12	FY13(F)	FY14(F)	FY15(F)
Revenue (m)	735	931	1,025	1,323	1,589
Pretax Profit (m)	243	258	285	393	477
Net Profit (m)	190	201	222	300	363
EPS (sen)	26.0	27.5	30.3	40.9	49.6
Pretax margin (%)	33.0	27.8	27.8	29.7	30.0
Net Profit margin (%)	25.9	21.6	21.6	22.7	22.8
PER (x)	17.4	16.4	14.9	11.1	9.1
DPS (sen)	10.5	10.8	13.6	18.4	22.3
Dividend Yield (%)	2.3	2.4	3.0	4.1	4.9
ROE (%)	38.5	32.5	35.8	32.9	33.7
ROA (%)	30.0	26.6	29.2	33.5	36.1
Net Gearing Ratio (%)	Net Cash	Net Cash	Net Cash	Net Cash	Net Cash
BV/Share	0.7	0.8	0.8	1.2	1.5
Price/Book Ratio (x)	6.7	5.3	5.3	3.7	3.0

Industry Outlook

- **Market leader**

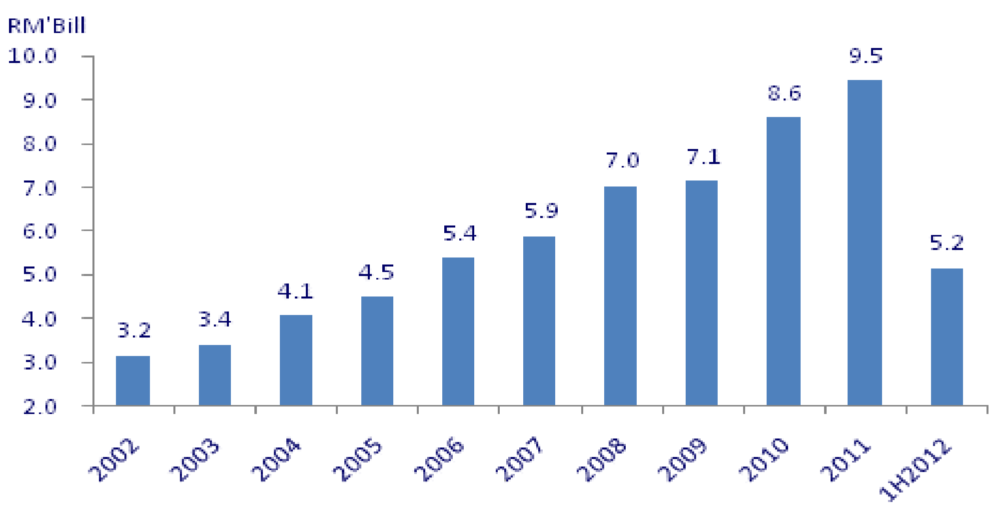
  Malaysia is the market leader in glove production, being where about 62% of global production originates from. World demand for gloves on average grew about 12% annually for the last 4 years and 8% annually since year 2000 and the demand for gloves is inelastic. The demand for medical gloves is resilient due to epidemics of diseases such as bird flu, severe acute respiratory syndrome, AIDS and other transmittable diseases. Bird flu is constantly evolving and there is no permanent vaccine for treatment. In this respect, examination gloves are constantly needed in the health care industry and are a necessity regardless of economic conditions. To conclude, rubber glove is a recession proof industry as glove consumption grew even during the 2008 global financial crisis and Europe's economic slow in 2011 (chart 1). Industry research suggests that global glove consumption will grow on average 8-12% annually.

- **Strong Demand for Nitrile Gloves**

  Demand for nitrile gloves has been growing due to lower product pricing, triggering a switch away from natural rubber gloves. (Table 2), markets in USA, Europe, Japan and South America have switched from latex gloves to nitrile gloves. Hartalega is the biggest synthetic rubber glove producer in the world. Hartalega commands about 16% of the synthetic rubber gloves market share in Malaysia at 2012. Another reason the nitrile gloves displacement of natural rubber gloves happened so swiftly is the growing awareness of latex allergy in developed nations and the increasing incidence of latex allergy in the general population. Latex allergy is a symptomatic response when a person is allergic to the proteins found naturally in latex or the industrial chemicals added during manufacturing. Symptoms of latex allergy are dermatitis, itchy skin, wheezing, falling blood pressure or anaphylactic shock.

  In all, the demand for nitrile gloves in developed countries is hitting the roof and we expect existing glove producers to attempt to penetrate the nitrile gloves market as gloom sets in over the latex gloves industry. Volatile natural rubber prices and declining demand for latex gloves have combined to push glove producers into the nitrile gloves market.

Chart 1 : Reslilent Malaysia Glove Exports



Source: MREPC

Table 2 : Nitrile Gloves replacing Latex gloves

	CY2010 (million pairs)			CY 2011 (million pairs)			% change	
Country	Latex	Nitrile	Ratio	Latex	Nitrile	Ratio	Latex	Nitrile
USA	5,778	6,891	55 : 44	3,640	7,620	32 : 68	(37)	11
EU	8,526	2,449	77 : 23	6,351	4,437	58 : 42	(26)	81
Japan	866	912	48 : 52	777	1,033	42 : 58	(10)	13
S. America	3,054	90	97 : 3	2,868	173	94 : 6	(6)	92

Source: MREPC

Table 3 : Characteristics of Latex Gloves vs Characteristics of Nitrile Gloves

	Latex	Nitrile
Strength	Dexterity Good for biological water based materials	Chemical and Puncture Resistant
Weakness	Allergy reaction Little chemical protection Hard to detect puncture holes	A little less agile then latex

Source: Inter -Pacific

- **Raw materials prices have stabilized**

  Raw material costs, including nitrile inputs, typically range between 40%-60% of a glove manufacturer's total costs. Nitrile prices have been on a decline since peaking in 4Q2011. Nitrile prices are influenced by rubber tyre production, which is closely related with vehicle production. The weakening of nitrile prices is due to a slowdown in China's and Japan's automotive industries. China's automotive sales growth fell to 7% from 35% in 2010 while Japan's automotive sales have contracted since 2009. We expect nitrile prices to stabilize as we expect more measures to ease traffic congestion in China's cities will cool down China's automotive industry.

Chart 2: Natural Rubber vs Nitrile

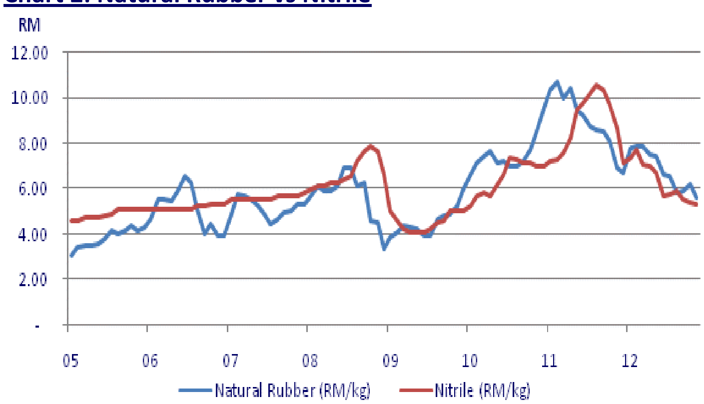
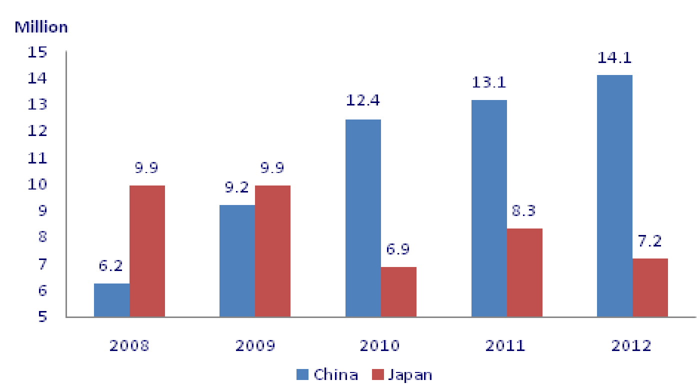


Chart 3 : Car sales growth in China slowing & contracting in Japan



Source: Bloomberg

Company's Background

Hartalega has an estimated combined annual installed capacity of 11.3b pieces of gloves from 51 production lines (FY2013). Currently, the utilization rate is 90%. All 51 lines operate in its 6 production plants located in close proximity to one another in Bestari Jaya. The company is an original equipment manufacturer (OEM) with a customer base of 137 companies located in 39 countries. The majority of its nitrile gloves are sold in USA and Europe and the principal glove product type is powder-free nitrile medical examination gloves. Hartalega gloves conform to the quality standards set by TÜV SÜD Management Service and Medical Device License (Health Canada) as well as many other quality standards. Hartalega has earned the reputation for producing the highest quality nitrile rubber gloves with the lowest rejection rate.

Furthermore, Hartalega is also known for its technological innovation. Hartalega is the first glove manufacture to implement double former production line, automated mechanical stripping system and automated glove stacking device. These technological advancements reduce labor costs and improve efficiency. Going forward, Hartalega will continue to pursue greater efficiency to improve scale economies by automating the packaging process. Furthermore, when Plant 6 is fully commissioned, 45 out of 55 Hartalega's production lines can be switched between latex and nitrile gloves production. All upcoming production lines are designed to accommodate this flexibility for a quick switch in products.

The company constructed its first 26-MW biomass plant in Bestari Jaya in 2002 which contributed RM4.7m savings in fuel consumption. Even though the fuel savings is small compare to its total operational costs of RM672m, it also provides renewable energy tax savings for the company.

Illustration 1 : Market Segments

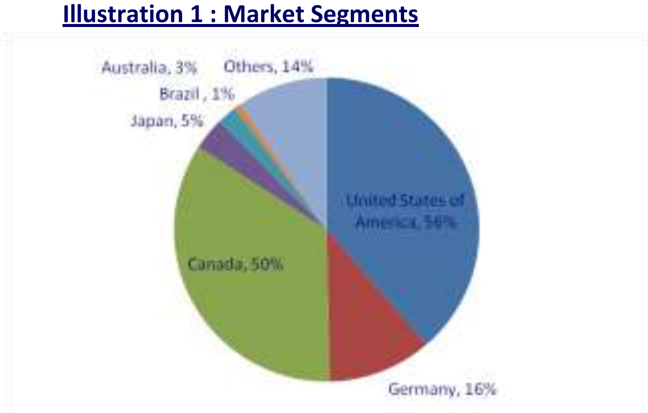
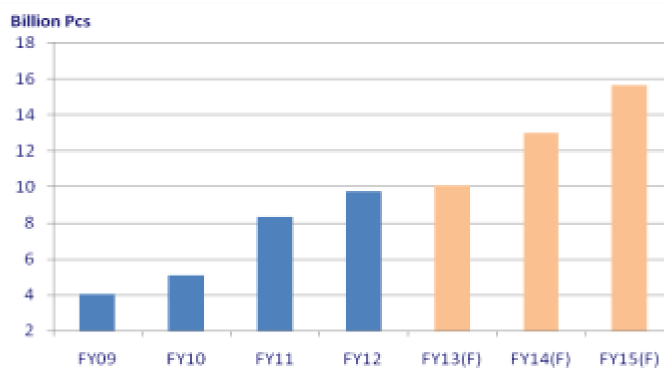


Chart 4 : Robust Production



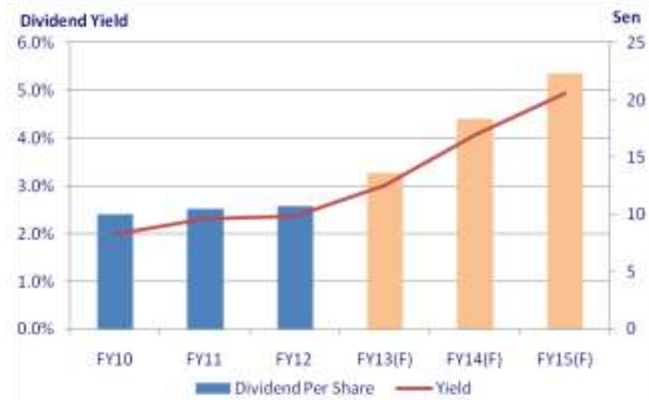
Source: Company, Inter-Pacific

Financials

Hartalega's net income grew at a CAGR of 65% from RM84m (FY09) to RM201m (FY12) due to rising glove production. The company has committed to pay out 45% of net income as dividends effective FY2012. We forecast net earnings will grow 49% from RM201m to RM 300m within two years in view of the capacity upgrades and cost savings from operating out of the Next Generation Integrated Glove Manufacturing Complex (NGC).

Chart 5 : Net Income (LHS) and ROE (RHS)

Chart 6: Dividend Yield (LHS) and Dividend per share (RHS)



Source: Company, Inter-Pacific

Investment merits

♦ **Build on Innovation**

Hartalega is banking on its technological innovation push to distinguish itself from competitors. The group's concentration on research and development has resulted in superior quality nitrile gloves and higher productivity from its advanced automated production facilities. Kuan Kam Hon (previous Managing Director) and Kuan Mun Leong (current Managing Director) are both steeped in engineering and innovation bias. Our conversations with management leaves us with the impression of a culture of engineering innovation permeating Hartalega, which results in higher productivity (Chart 7) and cost savings (Chart 8). Hartalega has the highest operating margin in the industry (Chart 9) mainly due to increasing automation and less reliance on foreign labour. Ultimately, being the most efficient and profitable glove producer leaves Hartalega head and shoulders above other industry players.

Chart 7 : Output Per Employee (billion pieces)

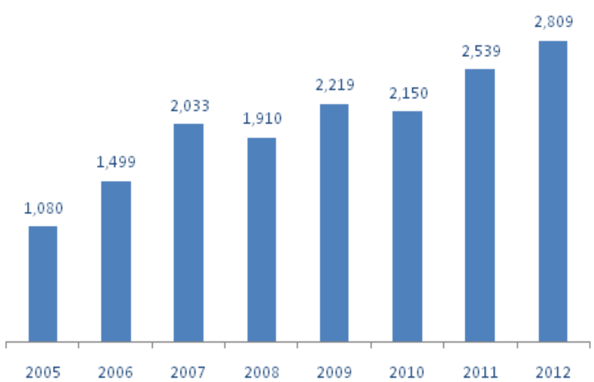
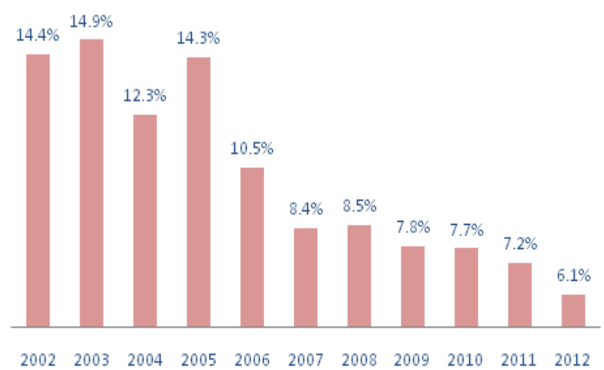


Chart 8 : Staff Cost as Percentage of Revenue



Source: Company

Chart 9 : Best margins in the glove industry

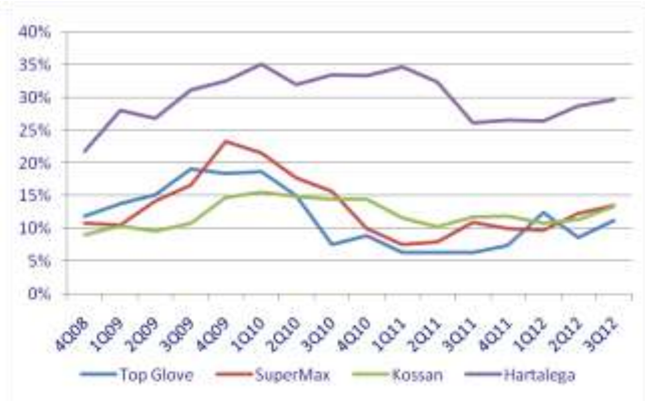
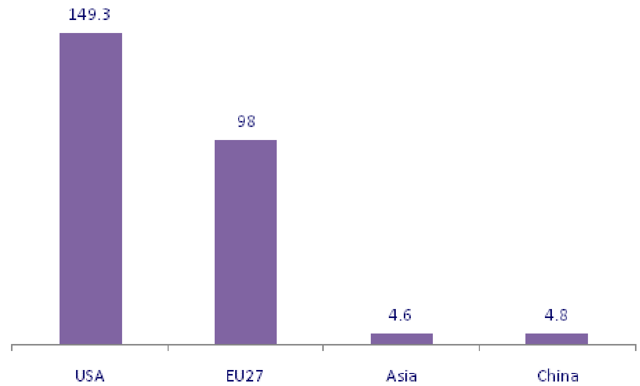


Chart 10 : Glove consumption per capita



Source: Companies

- **Growth Path Mapped Out**

In the pipe line is a RM1.5b integrated glove manufacturing facilities complex which houses 72 production lines, a renewable energy complex, training and development centre, and recreational complex and workers quarters that are part of the government's Economic Transformation Program. The Next Generation Integrated Glove Manufacturing Complex (NGC) in Sepang with an annual capacity of 28.3b pieces of gloves is expected to progressively increase its production from CY2014 till CY2021. NGC will more than quadruple Hartalega's current production level. Currently, Hartalega is in the process of finalizing purchase of the land. We believe NGC will be more efficient than the production plants in Bestari Jaya for the reason that it will generate greater economies of scale also helped by cheaper energy and even higher levels of automation.

In the past, Hartalega had correctly foreseen nitrile gloves would be a strong substitute for NR gloves and stayed one step ahead of its competitors. When developed nations switched to nitrile glove from NR glove, the company was able to leverage on the advantage offered by nitrile gloves. The next foreseeable growth in the glove industry is in Asia Pacific. Hartalega plans to establish a foothold for its nitrile gloves through its own brand manufacture (OBM) arm. The average consumption of gloves per capita in Asia pacific (Asia ex-Japan) is less than 5 pieces capita annum compare to USA (149 pieces) and European Union (98 pieces). Management sees the Asian region as offering strong growth opportunities given that rising disposable income in Asia region will lead to an increase in glove consumption.

We are aware the company is an OEM manufacturer and it is thus possible then in some instances it may end up competing against its erstwhile customers. However, Hartelage's OEM customers are more focused on developed nations and many have no presence in Asia. In this way, Hartalega's move to penetrate the Asian market will not necessarily pit it in direct competition with its existing customers. To date, Hartalega has established its marketing company in China and India.

Market Threat

- **Overcrowding**

  Due to the surge in demand for nitrile gloves in the developed nations, NR glove producers are expanding their capacity into nitrile gloves. The industry expects an increase of 21.8b pieces of nitrile glove capacity by end of CY13 from the top four listed glove players. The increase in supply will lower ASP for nitrile gloves and inevitably erode margins for nitrile glove producers. We believe supply will outpace demand in CY14 and return excess supply will be absorbed the following year. With respect to this expected supply glut, we expect it will pose a temporary hiccup for Hartalega. Every new production plant built improves profit margins by reducing overhead costs.

Valuation

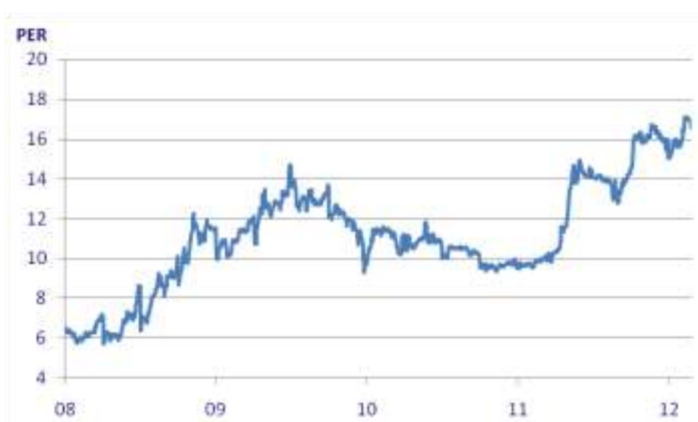
We recommend **BUY** on Hartalega Holdings Berhad with a target price of **RM5.73** (pegged to 14xPER FY14 EPS). Hartalega's PE ranges in the past 2-years between 9.6x-17.4x with the average at 12.7x. We are convinced Hartalega deserves a premium against the other gloves producers by reason of the company's strong management team, long term vision and structured planning with a focus on efficient operations built through technological innovation that ensures strong cash flows and an outstanding earnings margin. The main catalysts for potential price upside are 1) lower than expected raw material costs 2) USD appreciation against Ringgit.

Chart 11 : Ringgit Vs U.S. Dollar

Chart 12 : Historical PER Band

Source: Bloomberg

Chart 13 : Historical (Trailing) PER



Ratings System

Ratings:	Description:
BUY	Total return is expected to exceed 15% in the next 12 months
NEUTRAL	Total return is expected to be between above –15% to 15% in the next 12 months
SELL	Total return is expected to be below -15% in the next 12 months

Abbreviation

Abbreviation	Definition
PER	Price Earnings Ratio
PEG	PER to Growth
EPS	Earnings per Share
FYE	Financial Year End
FY	Financial Year
CY	Calendar Year
MoM	Month-on-Month
QoQ	Quarter-on-Quarter
YoY	Year-on-Year
YTD	Year-to-Date
p.a.	Per Annum
DCF	Discounted Cash Flow
FCF	Free Cash Flow
NAV	Net Asset Value

Abbreviation	Definition
CAGR	Compounded Annual Growth Rate
CAPEX	Capital Expenditure
DPS	Dividend per Share
ROA	Return on Asset
ROE	Return on Equity
PBT	Profit Before Tax
PAT	Profit After Tax
EV	Enterprise Value
EBIT	Earnings Before Interest And Tax
EBITDA	EBIT Depreciation & Amortisation
WACC	Weighted Average Cost of Capital
NTA	Net Tangible Asset
BV	Book Value

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