CLSA
ASIA-PACIFIC MARKETS

Hartalega

RM5.54 - BUY

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21 March 2011

Malaysia
Healthcare

Reuters	HTHB.KL
Bloomberg	HART MK

Priced on 17 March 2011
KLSE Comp @ 1,492.1

12M hi/lo RM6.08/3.20

12M price target RM7.40
±% potential +34%
Target set on 21 Mar 11

Shares in issue 363.5m
Free float (est.) 39.4%

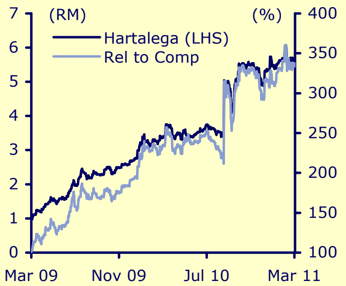
Market cap US$660m

3M average daily volume
RM2.1m (US$.7m)

Major shareholders
Hartalega Industries 50.6%
Budi Tenggara 5.1%

Stock performance (%)

	1M	3M	12M
Absolute	(8.0)	11.5	62.9
Relative	(7.0)	12.1	42.2
Abs (US$)	(8.2)	14.4	76.0



Source: Bloomberg

www.clsa.com

Winning-hand play

We initiate coverage of Hartalega, the world's No.1 synthetic nitrile-glove manufacturer, with a BUY recommendation to a RM7.40 target price, making it our favoured pick in the healthcare sector. We base this view on its ability to remain ahead of its peers through engineering and research, with its strategic foresight boosting profit. Hartalega now leads the pack with the widest margins and highest quarterly profit and we expect a total shareholder return (TSR) of 37%.

Blue-ocean strategy indeed
Hartalega's blue-ocean-strategy execution has simultaneously delivered product differentiation and lowered production costs. Its 2005 move to nitrile-glove production from the competitive and volatile natural rubber-glove market has placed the company in the best position to reap the benefits of current high rubber prices. Hartalega's focus on process engineering gives it good cost efficiency, making it one of the most profitable producers.

Pace setter
Hartalega became the world's No.1 synthetic-glove producer in 2010 after an 84% five-year volume Cagr in nitrile gloves. The company has stayed ahead of competitors through extensive R&D to reduce costs, while improving quality. This is evident from its margins, which are 10ppts wider than peers and are likely to remain strong. From 2H10, it has been the most profitable in the sector and this should continue, although rubber-glove producers will continue to suffer.

Switching will prevail
The glove industry has good pricing power as it passes on 70-80% of rising costs, albeit with a lag effect. For the first time, nitrile gloves are cheaper than natural-rubber ones due to 2010's 60% spike in latex prices, compared with 30% for nitrile. We believe latex will remain at an elevated RM10/kg until 2012, while nitrile should stay relatively stable. Given the premium for natural rubber, we believe switching to nitrile gloves will persist, in tandem with the structural shift in selected developed markets.

Rerating in place
In view of the rising earnings profile, we believe Hartalega deserves to trade in line with Top Glove's historical average of 12.0x prospective earnings versus Hartalega's current 9.0x 12CL PE. We forecast a 23% earnings Cagr for FY10-13CL with an attractive net yield of 3.9% and a net-cash position rising to RM0.85/share by FY13CL. Our PE-based target price of RM7.40 (12x FY12 PE and EPS of 61.9sen) implies 34% upside and a TSR of 37%.

Financials

Year to 31 Mar	09A	10A	11CL	12CL	13CL
Revenue (RMm)	443	572	735	863	1,039
Net profit (RMm)	85	143	187	225	263
EPS (sen)	23.3	39.3	51.4	61.9	72.4
CL/consensus (5) (EPS%)	-	-	102	103	105
EPS growth (% YoY)	21.5	69.1	30.7	20.4	17.0
PE (x)	23.8	14.1	10.8	9.0	7.7
Dividend yield (%)	1.4	2.4	3.2	3.9	4.6
FCF yield (%)	1.1	4.7	5.4	9.8	9.5
PB (x)	7.9	5.7	4.2	3.2	2.5
ROE (%)	38.9	47.0	45.0	41.0	37.2
Net debt/equity (%)	7.7	(9.4)	(16.9)	(32.7)	(39.1)

Source: CLSA Asia-Pacific Markets

Hartalega - RM5.54 - BUY

The business

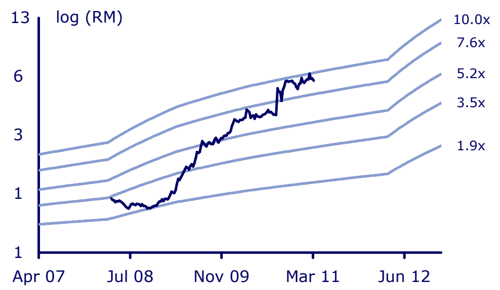
Hartalega was established in 1988 and manufactures and sells gloves. Its main focus is synthetic gloves, which provide an alternative for users who are latex sensitive, as some proteins in the organic variety can cause allergic reactions. The company now has 43 production lines with an annual capacity of eight billion gloves. Hartalega was listed on the Malaysian stock exchange in April 2008 and is the global No.1 in the synthetic-nitrile glove segment. The company exports almost 100% of its products to countries including the USA and China, as well as to South America.

Competition & market franchise

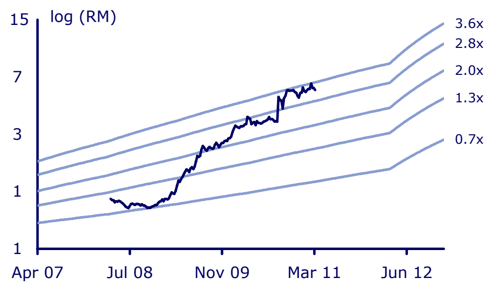
Hartalega specialises in quality high-end synthetic-nitrile gloves with a focus on being ahead of the industry in terms of technology. Also, nitrile gloves give the company better margins compared with its peers. Hartalega's net-profit margin is consistently above 20%, against the industry average of 15% or below. The company has a strong presence in the US market with 75% sales contribution. Furthermore, Hartalega has successfully increased its market share in the synthetic segment stateside from 2% in 2003 to its current 35%. It focuses on technology and manufacturing efficiencies to protect margin and profitability.

Valuation history

PE bands



PB bands

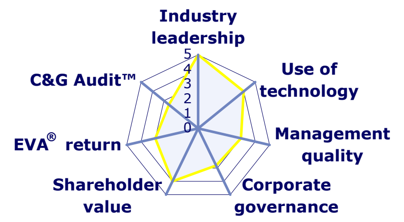


Comment

We expect Hartalega to rerate to Top Glove's historical average of 12x, from it is current historical average of 5.2x.

Bands (from the top): max, +1sd, avg, -1std, min.

Jet Stream® radar



Corporate governance at Hartalega

Criteria	Score	Country avg (%)	Country rank	Asia-xJ avg (%)	Sector rank
Discipline	88	64	2	55	2
Transparency	67	92	33	79	52
Independence	32	46	20	22	14
Accountability	25	29	15	52	65
Responsibility	61	57	9	55	20
Fairness	57	55	14	55	32
Social resp	65	63	11	50	23
Wtd CG score	**56**	**56**	**22/35**	**51**	**-**

Clean & Green Audit™

Criteria	Score
Leadership	1.00
Recognition	5.00
Disclosure	2.00
Looking to the future	3.00
C&G score/20	**10.24**

For details on methodology and scoring ranges across Asia, see our annual Clean & Green Audit report, which debuted in September 2006.

Outlook	1 year	Comment
***Jet Stream*® criteria**		
Industry leadership	✓	World No.1 nitrile-glove producer.
EVA® return	✓	Rising positive return.
Shareholder value	-	Weakening ROE is on rising shareholders fund, which implies room for capital management.
Corporate governance	-	Decent; a family-run business.
Management quality	✓	Dedicated with foresights.
Use of technology	✓	Highly-committed to improving business efficiency through technology.
CLSA Clean & Green Audit™	✓	Committed to alternative energy.
Valuations		
Earnings momentum	✓	Rising in a declining sector.
Price/earnings	✓	We expect the stock to rerate.
Price/book value	✓	At a decent level.
Macro factors		
Country risk	✓	Malaysia is a relatively stable market.
Strategy	✓	First mover advantages, strong R&D and foresight.
Liquidity	×	Liquidity is at low levels.
Technical analysis		Price action remains below the overhead resistance of RM5.70-6.08, and a break above the cited resistance level will be a bullish with a minimum upside target of around RM7.50-8.00.
Conclusion	**BUY**	

Blue-ocean strategy indeed

Create uncontested market space and make the competition irrelevant

Hartalega is reaping the benefits of implementing a blue-ocean strategy, which will see the company differentiating itself via product innovations and low-cost management through process engineering.

Strategic foresight

Move from natural rubber to synthetic nitrile glove

Domestic-glove manufacturing, predominantly an export industry, is mainly separated into two main segments; natural rubber and synthetic nitrile. Hartalega started operations in the natural rubber-glove manufacturing in 1988. However, in 2002, it decided to differentiate itself from the domestic industry as it began research on synthetic nitrile gloves. Synthetic nitrile is a close substitute to natural rubber as it has similar attributes without the protein-allergy risks.

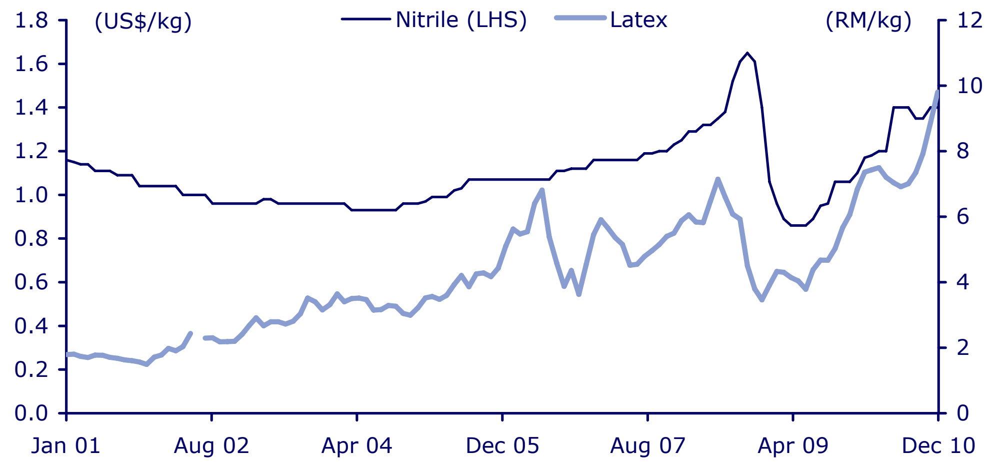
Hartalega believes its move to nitrile-glove manufacturing has allowed for better raw-material price management, as it is significantly less volatile. Moreover, as gloves are predominately an export industry, buying feedstock in US dollars provides a natural hedge against currency fluctuations. We discuss this issue further in the Section 3.

Natural rubber gloves use latex as the main feedstock, a commodity that is subject to violent price-trade movements. Meanwhile, synthetic rubber gloves use nitrile. Nitrile is a form of petrochemical, which has lower price volatility.

Latex prices are more volatile than nitrile

Figure 1

Nitrile versus latex prices



Source: Company, Bloomberg, CLSA Asia-Pacific Markets

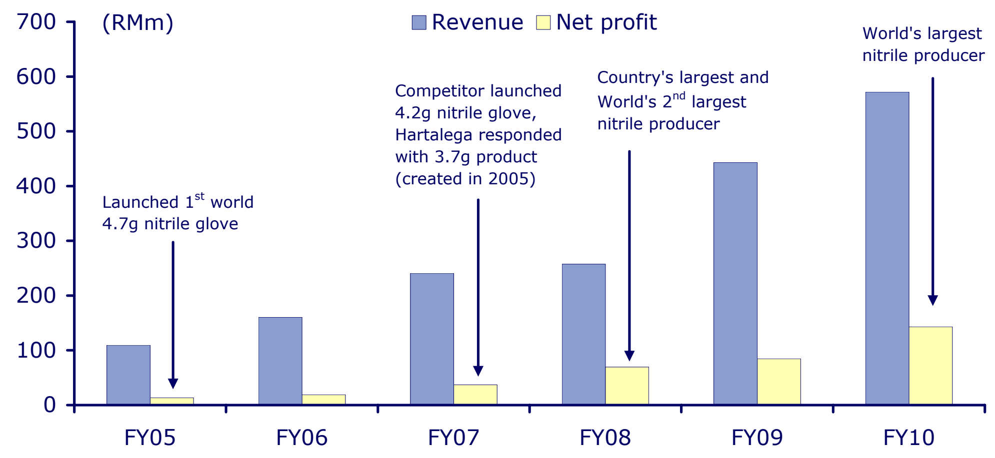
A step ahead

Hartalega launched its first synthetic nitrile glove in 2005: it took its competitor about two years (to 2007) to come out with a rival product. Knowing the need to remain a step ahead, the company's pipeline was ready with a superior product, developed concurrently with its first product in 2005.

Lower gram of glove requires less raw material hence reduces costs

Figure 2

Revenue and net profit evolution



Source: Company, CLSA Asia-Pacific Markets

R&D heightens barrier to entry

Hartalega is highly focused on research and development (R&D) to ensure continuous product innovation. Some parties have argued that it does not take much to start a glove manufacturing plant in view of the relatively small capital requirement. However, we believe the soft touches of R&D make a huge difference to entry barriers. This is especially significant due to the characteristics of synthetic nitrile, which needs careful R&D to ensure similar consistency to natural rubber gloves in terms of softness and elasticity.

Moreover, innovative R&D helps in maintaining product quality at lower unit production costs, which again increases the barrier to entry. Over the years, Hartalega has successfully reduced raw-material usage per unit while keeping product quality intact. Apart from FY09 when Hartalega faced some internal production issues, which have since been resolved, its nitrile and latex usage per 1,000 gloves have been steadily declining. This R&D enables Hartalega to benefit from either lower production costs or the ability to reduce prices without affecting margins.

Hartalega uses R&D to improve product quality and keep cost down

Figure 3

Nitrile used per 1,000 gloves

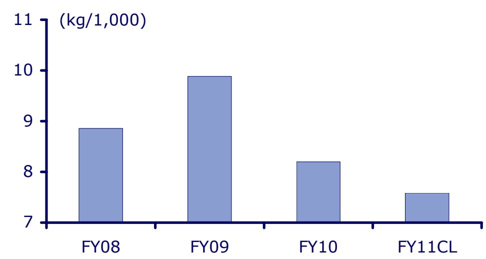
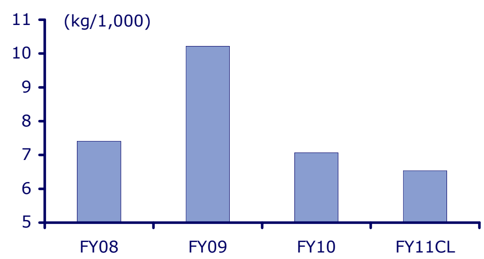


Figure 4

Latex used per 1,000 gloves



Source: CLSA Asia-Pacific Markets

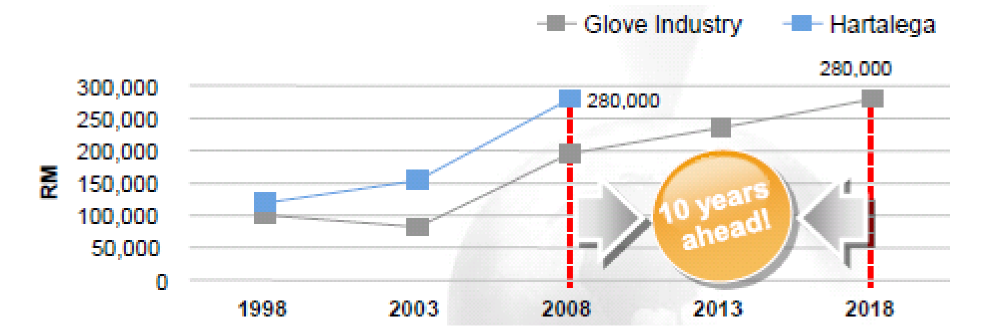
Process driven

Malaysian Rubber Glove Manufacturers' Association (MARGMA) considers Hartalega to be 10 years ahead of its competitors: an honour for its high efficiency through process engineering and automation. From our plant visits, we also contend that among listed-glove producers in Malaysia, Hartalega has one of the most impressive automation processes.

Automation enhances production

Figure 5

Revenue per worker per year



Source: Malaysian Rubber Glove Manufacturers' Association (MARGMA)

Hartalega focuses on automation throughout the entire production line while the industry is still heavily reliant on labour for the complete production process. Automation allows Hartalega to minimise labour requirements while the industry is increasingly faced with a labour shortage.

Hartalega's machines are in-house inventions and patented to remain ahead of its peers. In addition to minimising the need for labour, its machinery increases production capacity beyond human capability and ensures consistent quality. Continuous improvements in automation see Hartalega raising glove production on a per-staff basis each year, while keeping staff costs as a percentage of revenue unchanged.

Reduce staff requirement

Figure 6

Staff costs as a % of revenue

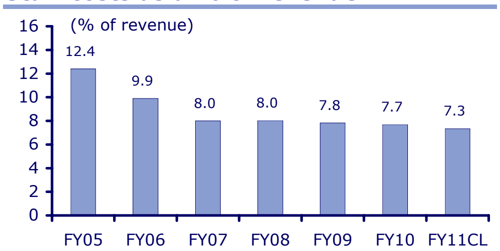
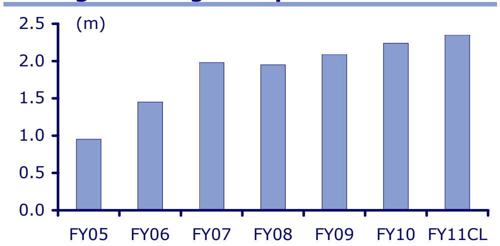


Figure 7

Average No. of gloves per staff



Source: Company, CLSA Asia-Pacific Markets

In its effort to further improve cost management, Hartalega also invested in a biomass energy plant which helps reduce energy costs. This is especially important with the Government's Transformation Program that will see a reduction in subsidy given to industry. Despite the significant electricity hike in June 2006 and July 2008, we continue to see reductions in energy costs per unit/revenue. In 2009 Hartalega experienced production hiccups hence the spike but this has since been resolved.

Clean and green with added cost benefit

Figure 8

Energy costs as a % of revenue

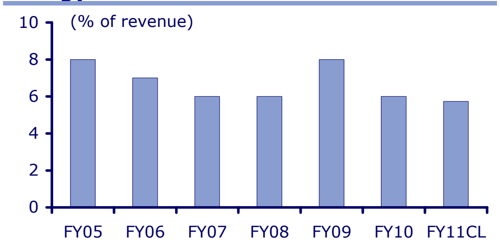
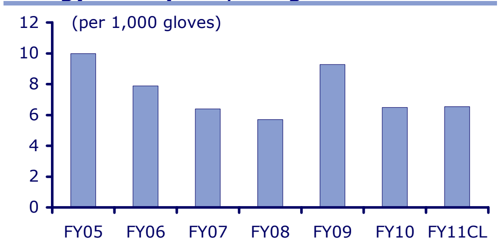


Figure 9

Energy costs per 1,000 gloves



Source: Company, CLSA Asia-Pacific Markets

Pace setter

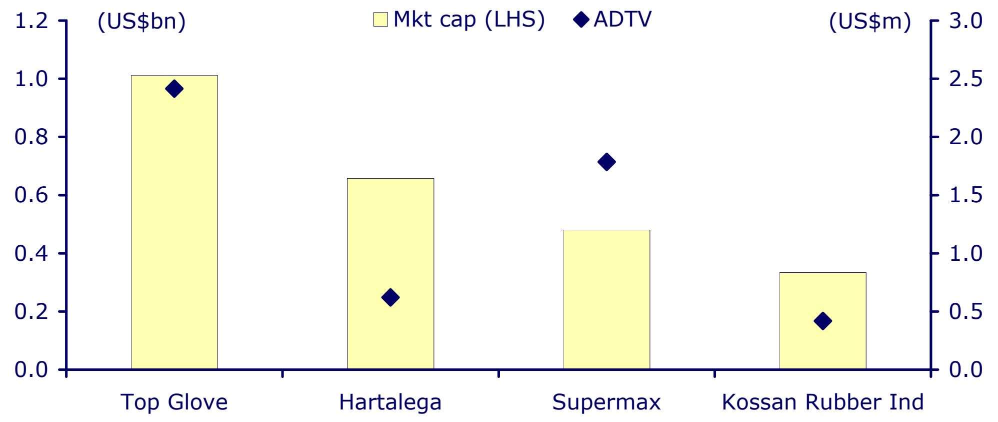
Achieved much in short time

Hartalega went public in April 2008 and is now the country's second-largest listed-glove producer, in terms of market capitalisation. We expect further growth, which should propel its market capitalisation close to its largest peer, Top Glove.

Hartalega is now the country's second-largest glove producer by market cap

Figure 10

Market capitalisation and average daily trade value



Source: CLSA Asia-Pacific Markets

Over the last six years, Hartalega's has achieved many firsts; including:

- **2004**: World's first double-former production line.
- **2005**: World's first 4.7g nitrile glove.
- **2007**: World's first 3.7g nitrile glove.
- **2008**: Country's largest nitrile glove manufacturer.
- **2010**: World's largest nitrile glove manufacturer.

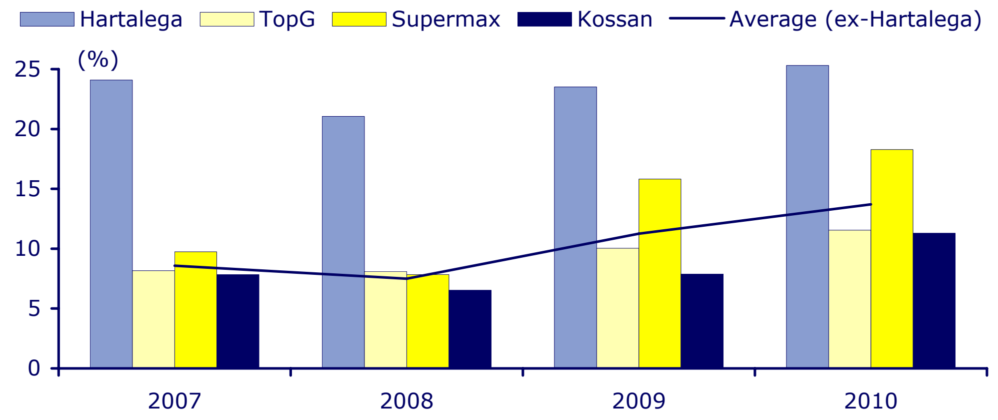
Superiority to remain

Throughout these periods, Hartalega continues to stay ahead of its competitors with the widest margin, almost double that of its peer average. We expect Hartalega's margins to remain wider than its competitors in the foreseeable future due to strong demand and continuous cost improvement.

Hartalega is a clear margin leader and rising

Figure 11

Net-profit margin



Source: CLSA Asia-Pacific Markets

As of 2H10, Hartalega recorded another first: it now leads with the highest reported quarterly profit. Among the top-four glove manufacturers by market capitalisation, Hartalega is the only entity that is recording rising profit, while the industry is seeing contraction following a super-normal-margin year prior to 2H10. Hartalega's contribution to the industry top four has risen from 13% in 1Q08 to 33% in 4Q10.

Hartalega leads in terms of quarterly profit

Figure 12

Net profit - Hartalega

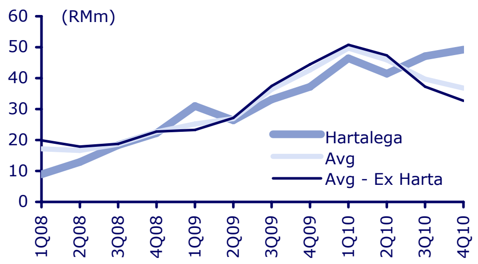
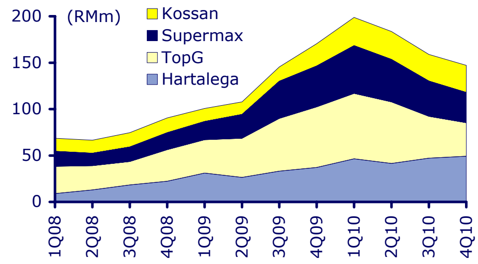


Figure 13

Net profit - Peer comparison



Source: Companies, CLSA Asia-Pacific Markets

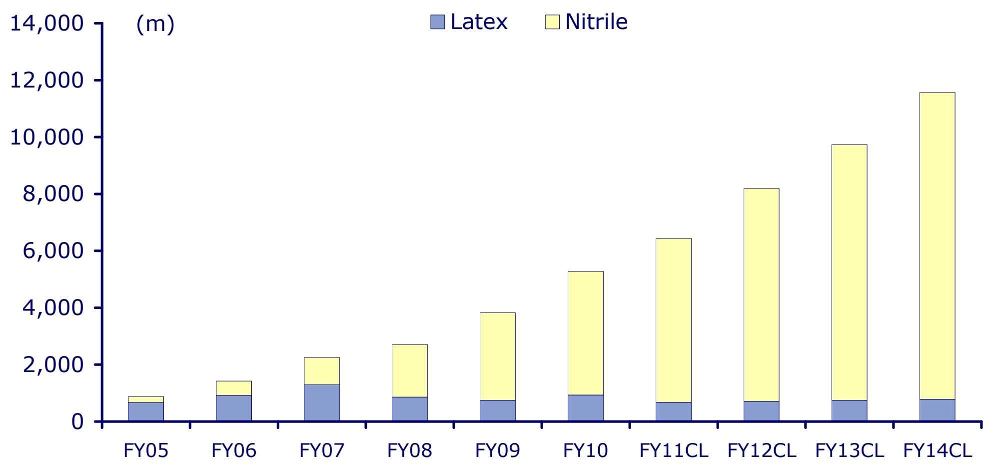
Hartalega was able to achieve these milestones on rising demand for nitrile gloves in addition to continuous efficiency improvement. Over the past five years, it has seen unit sales increase at an 84% Cagr.

Nitrile will continue to be a significant sales contributor

We expect Hartelega to see rising demand for its nitrile gloves with forecast unit growth of 32.5% in FY11, 30% in FY12 and 20% in FY13. Meanwhile, its natural rubber gloves will see only a marginal 5% unit increase per annum over FY11-13. Hence, we expect a further improvement in its volume sales split, with nitrile rising from 81% of the total in FY09 to 91% in FY12CL.

Figure 14

Hartelega volume sales: Nitrile and latex gloves



Source: Company, CLSA Asia-Pacific Markets

Nitrile offers wider margins

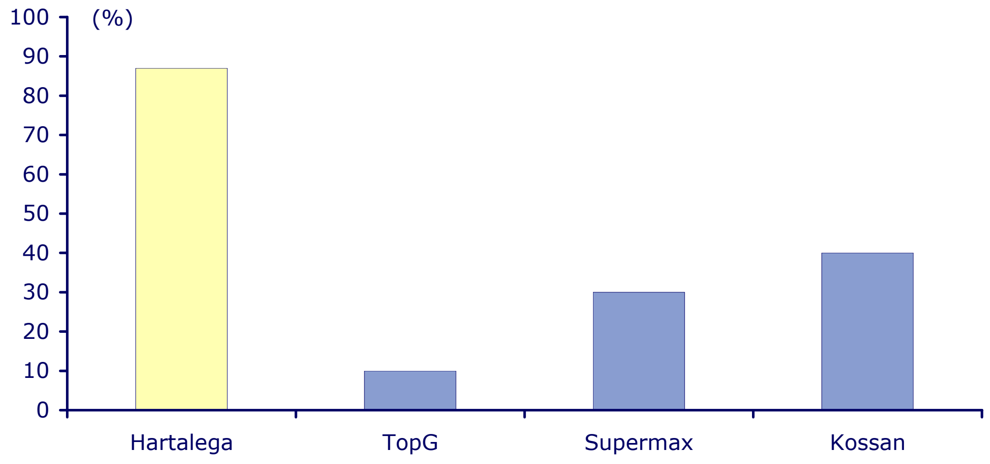
Historically, nitrile gloves have carried wider margins and better average selling prices than natural rubber gloves. Hence, the high proportion of nitrile glove sales ensures wide margins for Hartalega versus its peers.

The other top-three glove manufacturers have between 10% and 40% sales contributions from nitrile gloves. As such, it is not surprising that Hartalega's peers are looking to further increase their nitrile sales contribution by about 10ppts over the next one to two years.

Hartalega leads with highest nitrile-glove sales contribution

Figure 15

Nitrile gloves as % of sales as of 2010



Source: CLSA Asia-Pacific Markets

Market players are of the view that Hartalega's superior margins are due to lack of competition as nitrile glove sales constitutes less than one third of Malaysian total glove sales. We disagree and believe that the company's first-mover advantage and continuous R&D efforts give it the edge in producing better-quality products at cheaper costs than peers.

Raw materials - latex and nitrile - about 50% of production costs

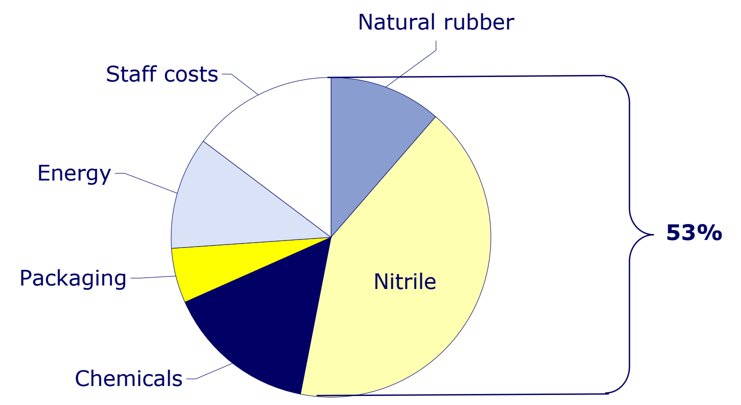
Switching will prevail

The biggest challenge to the glove industry is raw-material price management. Natural-rubber-glove manufacturers use latex as their feedstock. Meanwhile, nitrile gloves use synthetic rubber/nitrile, which is derived from petrochemicals. Raw materials, namely latex and nitrile, account for the biggest part - an estimated 50% - of glove-makers' production costs.

Raw materials constitute the largest portion of manufacturing costs

Figure 16

Hartalega: Manufacturing costs split estimate (2010)



Source: CLSA Asia-Pacific Markets

Combination of cost-plus and demand-supply dynamics

The industry tends to make regular adjustments to selling prices, depending on feedstock price movements. Typically, feedstock is quoted on a monthly basis. Under normal circumstances, the industry is able to pass through 70-80% of cost changes. Hence, glove pricing is a balance of a cost-plus mechanism and demand/supply dynamics.

One of the main reasons for Hartalega to move into nitrile glove production back in 2005, was feedstock pricing. Latex tends to see more price volatility than nitrile as the following charts depict.

Nitrile far less volatile than latex

Figure 17

Latex price movement - Monthly

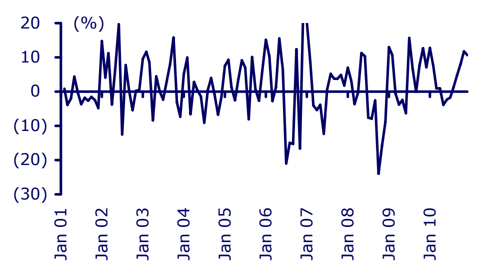
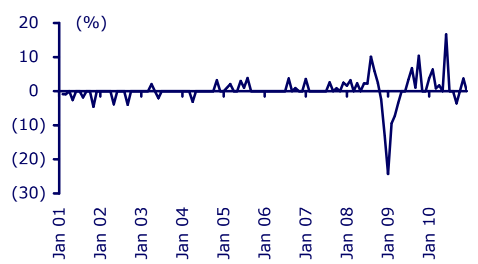


Figure 18

Nitrile price movement - Monthly



Source: Bloomberg, Company, CLSA Asia-Pacific Markets

Latex price is volatile

Using latex as a feedstock will leave companies vulnerable to price fluctuations, which vary significantly in different weather seasons. Rubber trees produce less during the wintering season, which occurs twice a year in 1Q and 3Q.

Drought occurs during wintering seasons, resulting in less photosynthesis following the fall in tree leaves. Meanwhile, severe rainy seasons see slower rubber-tapping activities. Hence, weather conditions affect the supply of latex, resulting in more volatile prices. The current situation is worsening as recent erratic weather patterns have not been following past trends, exacerbating cost management with raw materials at about 50% of production costs.

Weather conditions affect supply of latex, resulting in more volatile prices

Figure 19

Latex prices

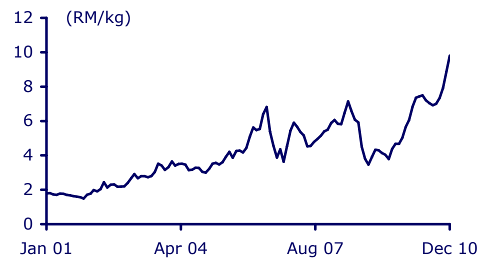
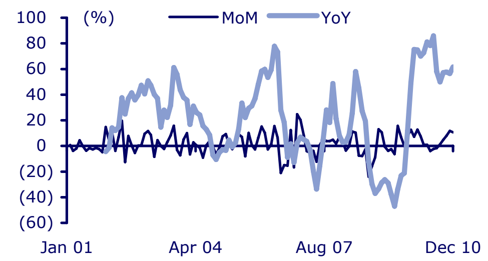


Figure 20

Latex price movement in %



Source: Bloomberg, CLSA Asia-Pacific Markets

Rubber prices tested new highs in 2010, with consumption running ahead of production globally. For Malaysia, the export of natural rubber was most evident for China, which doubled, followed by Germany, which recorded a 134% increase.

Over the past year, rubber prices are up 44% to RM9.80/kg in 2010. However, this is down 19% from recent peak of RM10.90/kg, as the wintering season should end in April or May. This could see a temporary supply improvement and hence lower rubber prices. Over the medium term, we expect to see rubber prices remain at elevated levels of RM10/kg as we expect strong demand for rubber to continue ahead of supply growth.

Strong demand for rubber

Figure 21

World rubber production & consumption

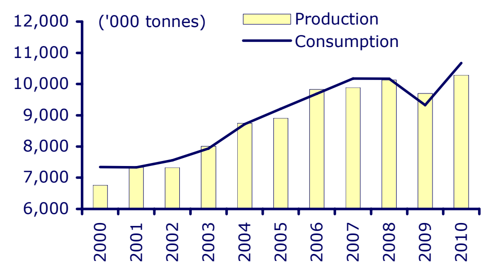
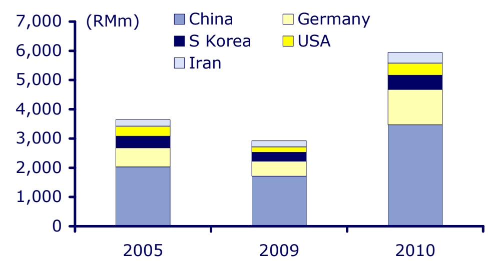


Figure 22

Malaysia's exports of natural rubber



Source: International Rubber Study Group, Department of Statistics

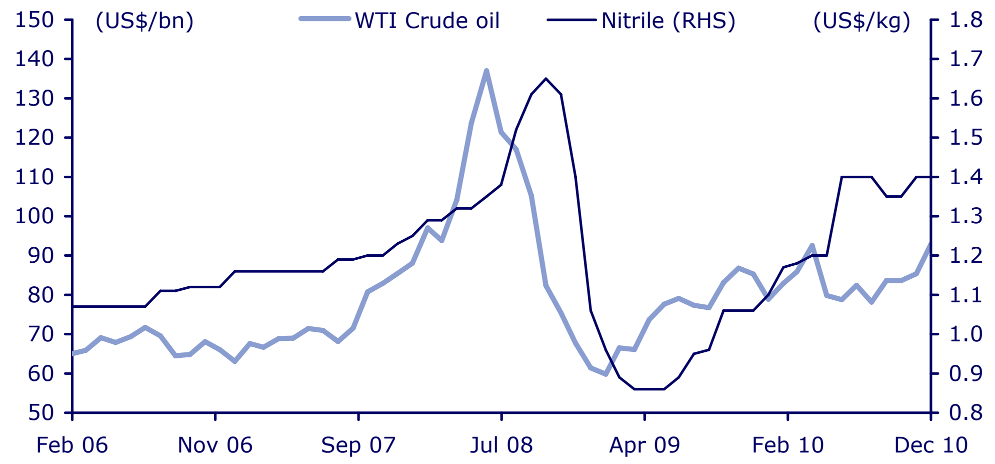
Nitrile correlated to oil

Meanwhile, synthetic nitrile is derived from petrochemicals, which are primarily correlated to oil prices. Nitrile prices tend to lag crude oil by a few months as it is not traded as a commodity and is quoted on a monthly basis. As such, this gives rise to greater price stability, hence easier cost and ASP management. Most global synthetic-rubber producers are in Asia, with Japan still a major contributor. Hartalega sources about 30% of its nitrile from Japan, and currently has 1.5 months of stock in hand. However, it may face temporary near-term cost pressures if production is not quickly restored after the recent Japan earthquake.

Nitrile price is related to WTI crude oil price movement with lag effect

Figure 23

Price movement: WTI crude oil and nitrile



Source: CLSA Asia-Pacific Markets, Bloomberg, Company

For the first time

There's a first for everything

The rule of thumb on the price differential between natural rubber and nitrile gloves is that if latex prices are more than double the price of nitrile, natural rubber gloves will be more expensive than nitrile gloves.

For the first time in history we see nitrile gloves being priced more cheaply than natural rubber gloves. In the past, nitrile gloves were priced at a 30% premium to rubber gloves. Today rubber gloves are at a 30% premium to nitrile. We expect this trend to continue until 2012 as we believe elevated latex prices will continue until then. Meanwhile nitrile prices, correlated to crude-oil prices, will remain comfortable within their historical band. The glove industry, including Hartalega, has decent pricing power in being able to pass on higher costs (albeit not all), which should continue to see rising glove prices as costs continues to increase.

Latex gloves will be priced at a premium to nitrile in view of elevated rubber prices

Figure 24

ASP: Latex vs nitrile gloves

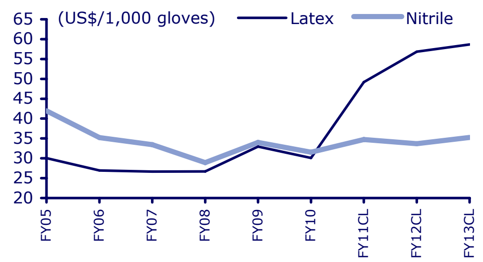
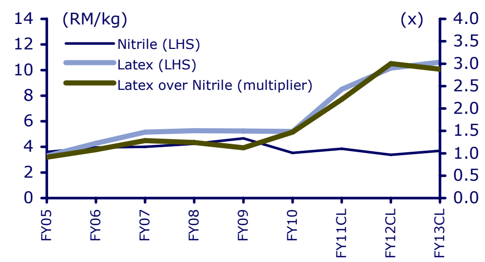


Figure 25

Feedstock price



Source: Company, CLSA Asia-Pacific Markets

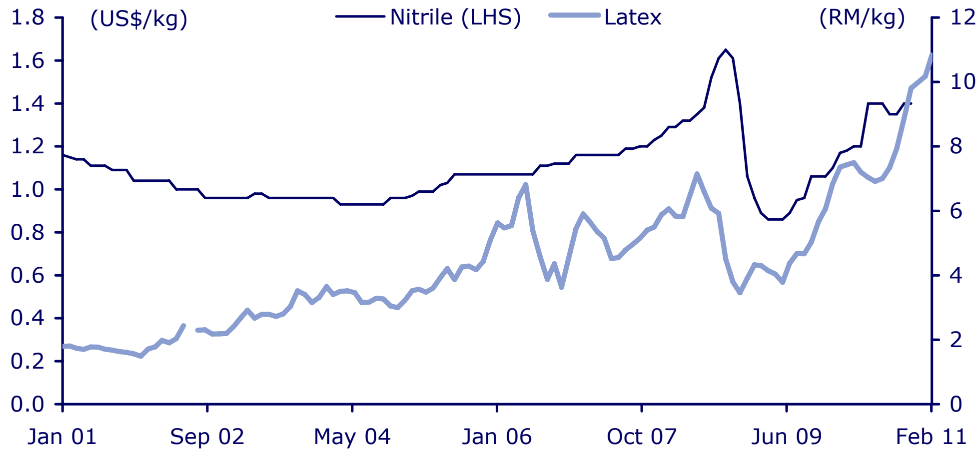
One moving way ahead of the other

The higher pricing for natural rubber gloves is predominately a result of the recent elevated latex price level. Meanwhile, nitrile gloves have not seen significant price changes as nitrile has remained in a relatively stable US$0.90-1.65/kg band. From the recent trough in 2009, latex prices are up 60%, while nitrile prices are up 30%.

Nitrile has less price volatility versus latex

Figure 26

Nitrile versus latex prices



Source: Bloomberg, Company, CLSA Asia-Pacific Markets

High price to remain until 2012

The price of latex has ballooned since 2003 from RM2/kg to its current RM8.60/kg. We expect prices to remain at an elevated level on tight supply and demand conditions, but with significant price volatility in between. New supply will likely enter the market sometime in 2012 hence will see a downward price movement only in 2013. Rubber-tree planting activities for latex harvesting, which began in the 2005-09 period will take about five years to reach maturity.

Glove manufacturers are not the largest consumer of natural rubber. Hence, natural rubber-glove demand is not the best indicator for potential demand when thinking about possible effects on pricing. The tyre industry uses about 70% of the global natural-rubber supply. Therefore, with the rising demand for transport (car and airlines), demand for natural rubber will continue and sustain higher rubber prices ahead.

Structural shift - Developed markets

Structurally, developed markets have shown preference for nitrile gloves

The shift to nitrile glove demand due to the widening price differential with rubber gloves is something relatively new to the industry. However, in developed Western markets such as the United States, there has been a structural shift to nitrile. The protein allergy issue that arises from using natural rubber gloves propelled the shift.

This has prompted Hartalega to focus on synthetic nitrile gloves with low protein content, creating a viable substitute for natural rubber gloves. As such, North America and Europe saw 38% and 46% Cagrs in revenue in 2005-10.

We see this structural shift in demand for nitrile gloves continuing. Potentially this could happen at a faster pace now, in view of the widening pricing differential with rubber gloves.

Hartalega sees high sales contribution from developed markets

Figure 27

Sales to North America

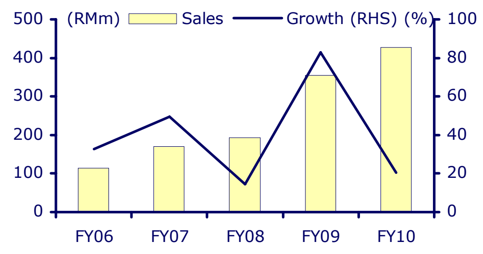
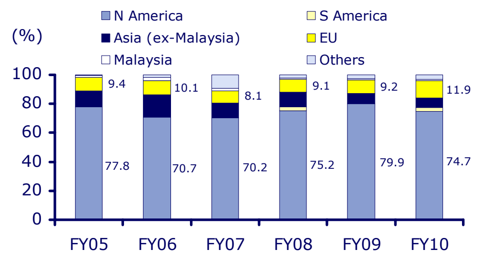


Figure 28

Sales split by region



Source: Company, CLSA Asia-Pacific Markets

Nitrile seeing rising capacity

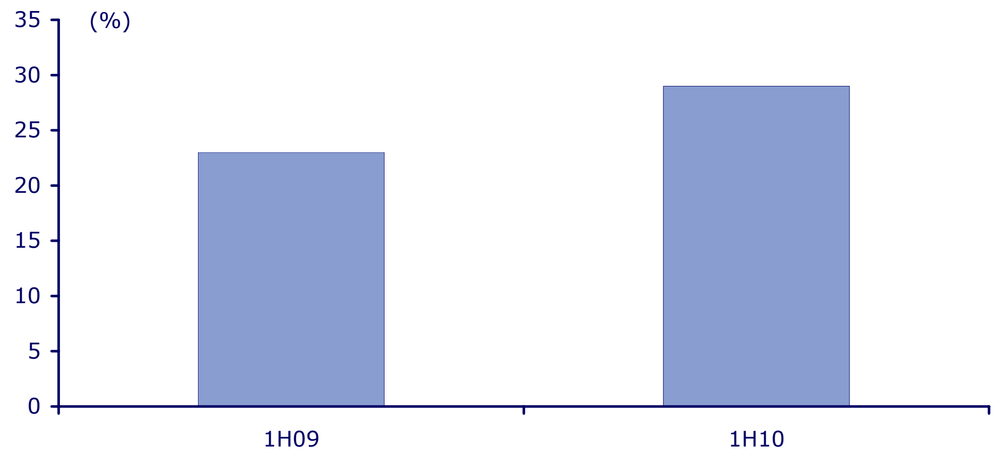
Where there is demand supply will follow

Following the rise in demand for nitrile gloves, we have seen increased industry production plans towards nitrile gloves with almost all new capacity geared towards nitrile glove production. The industry is now looking to increase production lines catering to nitrile gloves from 20-30% to 30-45%. This could place margin pressure to the nitrile glove segment, if supply runs ahead of demand. However, we do not believe this will be the case.

Nitrile glove sales have been rising

Figure 29

Malaysia: Nitrile glove sales % of total sales



Source: Malaysian Rubber Export Promotion Council (MREPC)

Demand for nitrile gloves will continue due to price

Nitrile gloves will continue to be priced cheaper than natural rubber gloves due to elevated latex prices, and thus we should see a prolonged and potentially permanent preference for nitrile gloves. Also, the increase in the scale of nitrile glove production will lower average production costs on a per unit basis, and hence sustain Hartalega's margins. We expect the company's Ebitda margins to rise from 34.9% in FY10 to 37% in FY12CL.

Rerating in place

Rising in a declining environment

Hartalega is now the only glove manufacturer that is reporting earnings growth while its peers are in a declining earnings environment. Hartalega's strong earnings growth is on rising demand for nitrile gloves and margins preservation. Hence it is not surprising that Hartalega is now the second-largest glove manufacturer in the country by market capitalisation. We initiate coverage on Hartalega with a BUY rating to a RM7.40 target price.

Hartalega now leads the pack

Figure 30

Revenue per quarter

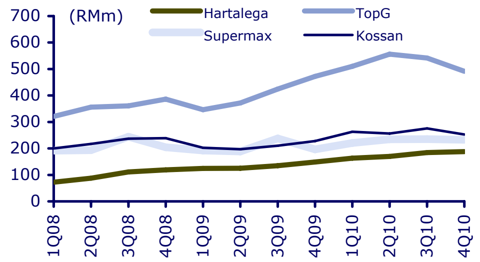
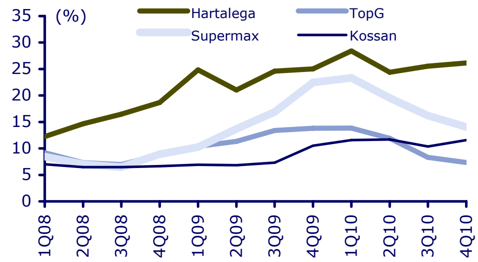


Figure 31

Net profit margin per quarter



Source: Company, CLSA Asia-Pacific Markets

We expect rising earnings for Hartalega, in view of its first-mover advantage in the nitrile glove segment, which is in line with consensus. The market is forecasting rising earnings for Hartalega but it has been lowering its expectations for the rest of the industry.

Consensus see declining earnings to the industry ex-Hartalega

Figure 32

Consensus EPS, glove makers FY11/12

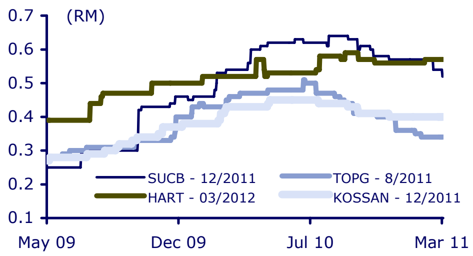
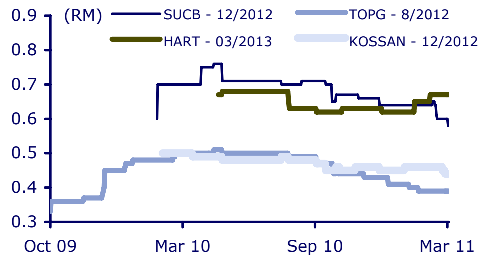


Figure 33

Consensus EPS, glove makers FY12/13



Source: Bloomberg

We have assumed further annual increases of 20-30% in demand for Hartelega's nitrile gloves in FY11-13CL, after the company registered an 84% Cagr in the past five years (2005-10). Hartalega has a headstart in terms of product superiority hence customer confidence. It is also well established in the nitrile segment and will continue to benefit from the structural shift into nitrile gloves as it is the go-to supplier for them. Hartalega has successfully widened its customer base too, as the contribution to sales from its top-two customers have declined from 50% in FY08 to 40% in FY11.

This strong demand for nitrile gloves will see an increase in volume sales split from 82% in FY10 to above 90% in FY12-13CL. The high split of wide-margin nitrile gloves will help Hartalega sustain its superior margins. Moreover, the higher demand for nitrile gloves will see strong pricing power for Hartalega to pass on rising costs, if any.

Nitrile gloves will continue to be the main contributor

Figure 34

Hartalega revenue by glove segment

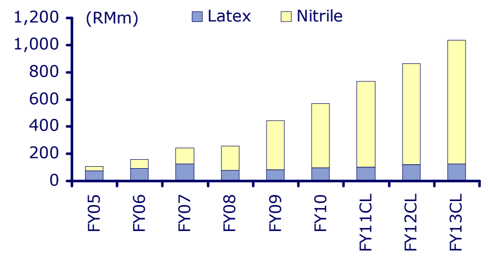
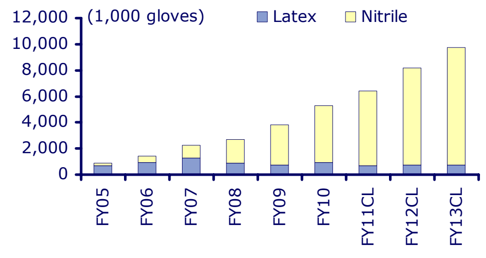


Figure 35

Hartalega sales volume by segment



Source: Company, CLSA Asia-Pacific Markets

We are not expecting a significant increase to Hartalega's main feedstock, nitrile, which we believe will remain stable in the US$1.15-1.28/kg band over FY11-13. This is within its historical range of US$0.95-1.6/kg. The movement in nitrile is consistent with our regional oil and gas team's WTI crude oil estimates.

Nitrile change is consistent with WTI crude oil price forecasts

Figure 36

Nitrile price and change (YoY)

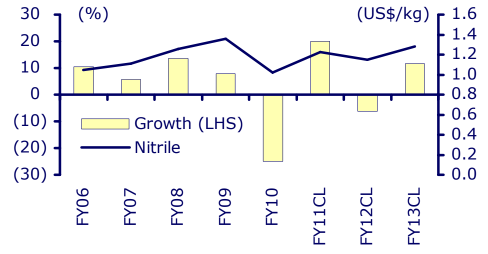
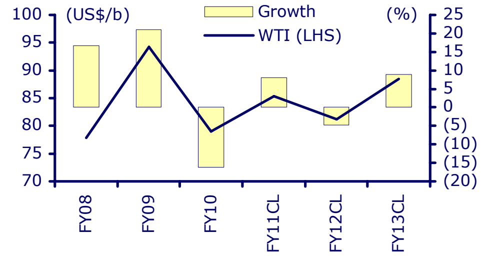


Figure 37

Crude Oil (WTI) price and change (%)



Source: Company, CLSA Asia-Pacific Markets,

Meanwhile, we see rubber prices remaining at an elevated level and further increasing to reach an average peak of RM10.62/kg by FY13, doubling its historical average of RM4.74/kg. In view of the sales split favouring nitrile gloves, latex costs represent a small portion - less than 10% - of overall costs and only about 5% of revenue. This further minimises the cost pressure risks for Hartalega arising from high latex prices.

Latex price will remain above RM10/kg level

Figure 38

Latex price and change (%)

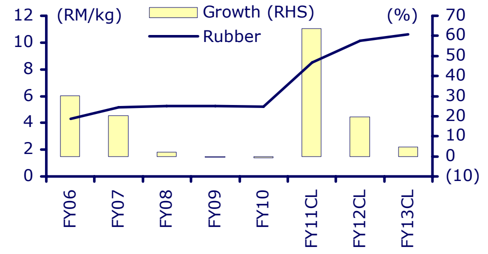
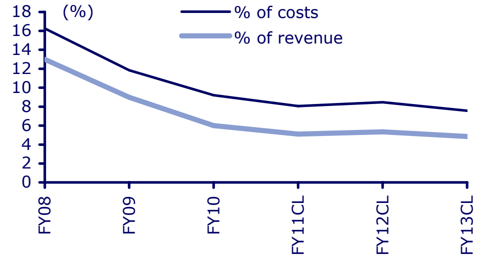


Figure 39

Hartalega latex as % of costs & revenue



Source: Company, CLSA Asia-Pacific Markets

To be consistent with our regional economist team we have assumed a stronger ringgit. This affects Hartalega's export receipts, which are mainly in US dollars. However, Hartalega has a natural hedge of about 20%, which is from its nitrile feedstock purchases. Also, typically Hartalega can pass through at least 70% of rising costs to its customers.

Nitrile are purchased in US$ hence gives a natural hedge to export sales

Figure 40

Hartalega sales split by region in 2010

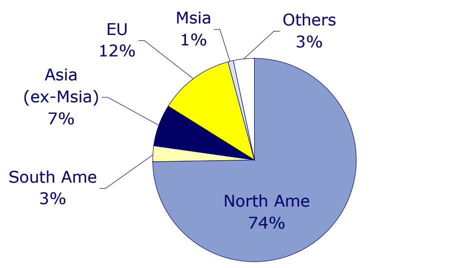
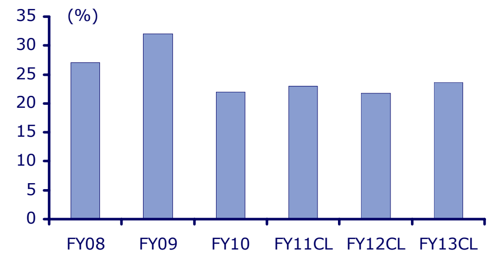


Figure 41

Hartalega nitrile costs as % of revenue



Source: Company, CLSA Asia-Pacific Markets

All-in-all, we expect a 23% earnings Cagr for FY11-13CL on stronger demand. We see Ebit margins expanding despite rising competition as we believe the company will be able to maintain its superior margins through improved efficiency, technological advances in processing methods, and by product developments to achieve similar or better quality at a lower cost.

Earnings will still be strong

Figure 42

Hartalega revenue and net profit growth

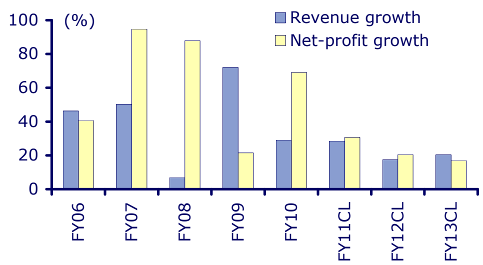
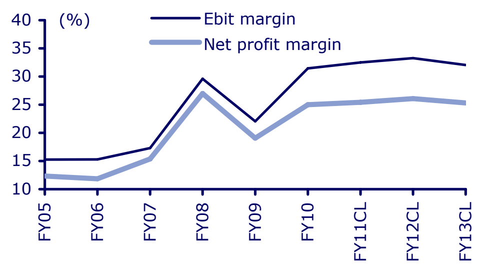


Figure 43

Hartalega Ebit and net profit margins



Rising profits

Figure 44

Income statement

March YE (RMm)	**09A**	**10A**	**11CL**	**12CL**	**13CL**
Revenue	**443.2**	**571.9**	**734.9**	**862.7**	**1,038.7**
Costs	(336.4)	(372.2)	(467.1)	(543.7)	(667.9)
Natural rubber	(39.9)	(34.3)	(37.6)	(46.0)	(50.5)
Nitrile	(141.8)	(125.8)	(168.5)	(187.4)	(245.3)
Chemicals	(31.0)	(45.8)	(55.8)	(66.9)	(79.4)
Packaging	(17.7)	(17.2)	(20.9)	(26.6)	(31.6)
Energy	(35.5)	(34.3)	(42.2)	(44.1)	(53.9)
Staff costs	(34.6)	(44.0)	(53.9)	(69.1)	(82.4)
Other costs	(35.8)	(70.8)	(88.2)	(103.5)	(124.6)
Ebitda	**113.2**	**199.7**	**267.8**	**319.0**	**370.8**
Depn	(15.5)	(19.8)	(28.9)	(31.9)	(37.9)
Ebit	**97.7**	**179.9**	**238.9**	**287.1**	**332.9**
Finance costs	(2.4)	(3.4)	(2.6)	(2.6)	(2.6)
Int income	0.2	1.3	3.4	4.1	7.2
EI	6.4	0.0	0.0	0.0	0.0
PBT	95.5	177.8	239.7	288.6	337.6
Taxation	(11.0)	(34.7)	(52.7)	(63.5)	(74.3)
MI	(0.0)	(0.1)	(0.2)	(0.2)	(0.3)
Net profit	**84.5**	**142.9**	**186.8**	**224.9**	**263.0**

Source: CLSA Asia-Pacific Markets

Rerate on multiple reasons

Trade in line with Top Glove

Hartalega has a short trading history versus its listed peers, with its IPO in April 2008. Since its listing, Hartalega has traded at an average forward PE of 5.2x. In view of its improved operating environment we expect the company to rerate. Our target price is based on Top Glove's 10-year forward PE trading average of 12x. Using 12x PE and FY12 EPS of 61.9sen, implies a target price of RM7.40, for 34% upside and a TSR of 37%.

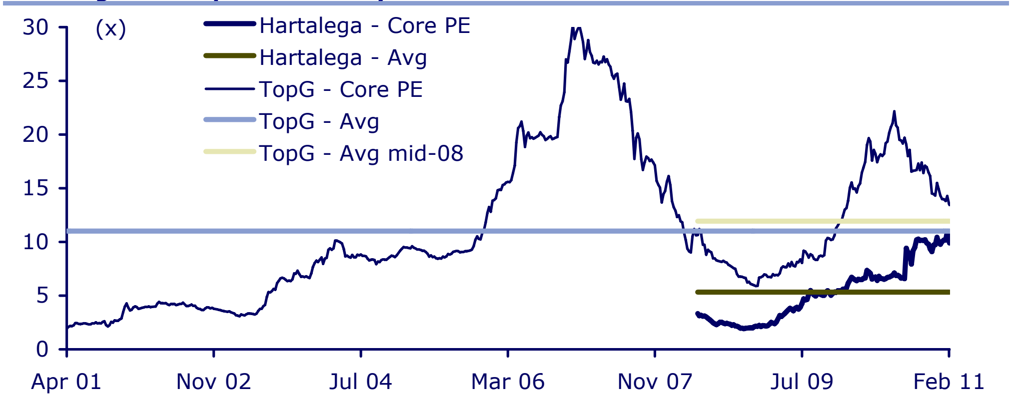
Moreover, Hartalega is now the leading glove manufacturer in terms of margins and quarterly profitability. We believe while the glove industry is still going through an adjustment period of margin and demand normalisation; Hartalega will continue to see margin expansion, hence earnings increase on rising demand. The company's technological and R&D superiority should not be underestimated as a means to counter rising competition, as well as increasing barriers to entry.

Long-term potential

Over the next three years, we do not discount the possibility of Hartalega reaching 14x PE multiple on rising earnings and potentially evolving into a mid-sized listed entity with improved market liquidity. At that point, the potential fair value could reach RM12.20 with TSR of 119% by FY14.

Figure 45

Hartalega and Top Glove: One-year forward PE



Source: CLSA Asia-Pacific Markets

Balance sheet gets stronger

Net cash to grow

Hartalega will continue to see a rising cash position from its already healthy balance sheet with a net cash of RM0.24 per share in 3QFY11. We see the net cash position rising to RM0.85 per share by FY12, assuming a consistent payout ratio of 35%. Hartalega has a dividend payout policy of 35-40%, which would result in a net yield of 3.9% in FY12. Its attractiveness is further enhanced as the payment is made on a quarterly basis.

Strong cash position

Figure 46

Net debt/cash per share

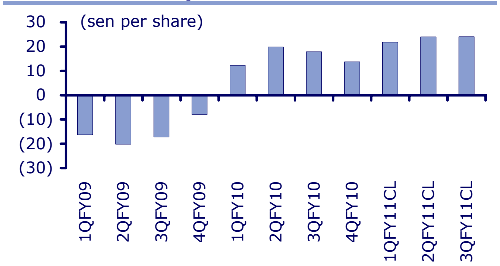
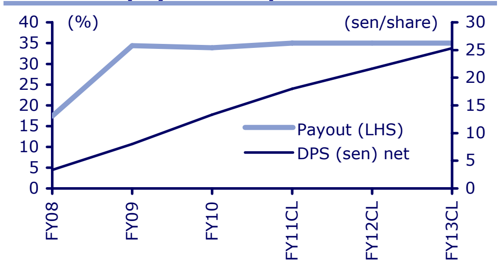


Figure 47

Dividend: payout and per share



Source: CLSA Asia-Pacific Markets

Room for better dividend payment

We believe there is room for Hartalega to further increase its dividend payout despite its capex requirement of RM50-100m for FY11-12. The company has seen positive and rising free cashflow (FCF) since FY09 and should see FCF go from RM23m in FY09 to about RM200m in FY12/13CL.

Investors should not be alarmed by the declining ROE, as the decline is a function of fast-rising shareholders' funds versus net profit. Meanwhile, looking at EVA®, Hartalega will continue to report a rising amount from less than RM50m prior to FY10 to RM200m by FY13.

Rising EVA®

Figure 48

Data for EVA®

March YE		08A	09A	10A	11CL	12CL	13CL
COE (%)		10.9	10.9	10.9	10.9	10.9	10.9
Wacc (%)		10.6	10.5	10.5	10.5	10.5	10.5
ROIC (%)		16.7	30.5	44.7	48.2	51.5	54.2
EVA® (RMm)		14.2	52.9	110.7	145.8	178.2	209.4
Risk-free rate (%)	3.9						
Market risk premium (%)	6.3						
CAPM Beta for the stock (x)	1.1						

Healthy balance sheet

Figure 49

Balance sheet

March YE	09A	10A	11CL	12CL	13CL
Non-current assets	**246.4**	**293.0**	**339.1**	**357.2**	**419.3**
Property, plant & equip	246.1	284.2	330.3	348.4	410.5
Capital WIP		8.4	8.4	8.4	8.4
Prepaid lease	0.2	0.1	0.1	0.1	0.1
Intangible asset		0.1	0.1	0.1	0.1
Others	0.2	0.2	0.2	0.2	0.2
Deferred tax asset		0.0	0.0	0.0	0.0
Current assets	**128.4**	**185.8**	**272.0**	**407.6**	**530.9**
Inventories	24.6	28.1	44.7	39.2	31.5
Trade & other receivables	65.5	83.0	106.6	125.2	150.7
Tax assets	0.1	0.1	0.1	0.1	0.1
Cash	38.3	74.7	120.6	243.2	348.6
Total assets	**374.8**	**478.9**	**611.1**	**764.8**	**950.2**
Share capital	121.2	121.2	181.7	181.7	181.7
Reserves	133.3	232.9	292.7	438.2	607.9
Shareholder funds	254.4	354.1	474.5	619.9	789.6
Minority interests	0.1	0.3	0.5	0.7	1.0
Total equity	**254.5**	**354.4**	**474.9**	**620.7**	**790.6**
Non-current liabilities	**67.5**	**55.5**	**55.5**	**55.5**	**55.5**
Loans	42.7	27.7	27.7	27.7	27.7
Deferred tax liabilities	24.8	27.8	27.8	27.8	27.8
Current liabilities	**52.8**	**69.0**	**80.7**	**88.6**	**104.1**
Trade and other payables	36.2	44.4	56.1	64.0	79.5
Loans	15.1	13.7	13.7	13.7	13.7
Tax liabilities	1.6	10.9	10.9	10.9	10.9
Total liabilities	**120.3**	**124.5**	**136.1**	**144.1**	**159.6**
Total equity & liabilities	**374.8**	**478.9**	**611.1**	**764.8**	**950.2**

Source: CLSA Asia-Pacific Markets

Capital management and M&A: Potential

In view of its strengthening balance sheet, we believe there is room for better capital management. Hartalega also has the choice to use its rising cash position for potential acquisitions. However, finding the right fit and price may be difficult. We believe the company will be prudent and will not overpay or buy unsuitable investments.

Rising value and earnings

Figure 50
EVA®

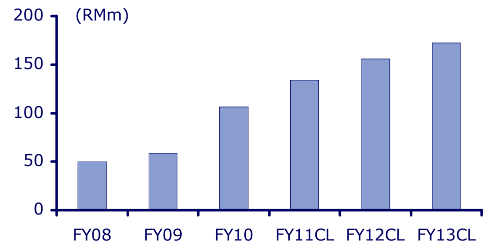
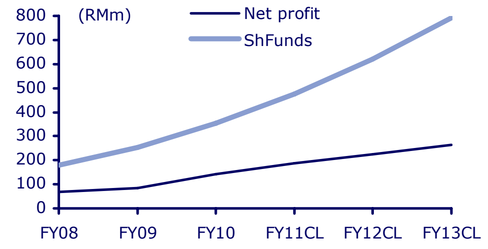


Figure 51
Net profit and shareholders fund



Stronger cash position

Figure 52
Cashflow statement

March YE (RMm)	09A	10A	11CL	12CL	13CL
PBT	**95.5**	**177.8**	**239.7**	**288.6**	**337.6**
Depreciation	15.5	19.8	28.9	31.9	37.9
PPE related	(0.0)	0.4	0.0	0.0	0.0
Debt related	(0.0)	0.0	0.0	0.0	0.0
Other asset related	0.0	0.0	0.0	0.0	0.0
Interest exp	2.4	3.4	2.6	2.6	2.6
Interest income	(0.2)	(1.3)	(1.4)	(2.7)	(4.6)
Forex	0.1	3.2	0.0	0.0	0.0
Others	0.4	0.1	0.0	0.0	0.0
OCF before working cap	**113.7**	**203.4**	**267.8**	**319.0**	**370.8**
Inventories	(2.5)	(3.5)	(16.6)	5.6	7.6
Receivables	(26.0)	(21.3)	(23.6)	(18.5)	(25.5)
Payable	5.7	9.8	11.7	8.0	15.5
Cash from operating CF	**90.8**	**188.5**	**239.2**	**314.0**	**368.4**
Interest paid	(3.3)	(3.4)	(2.6)	(2.6)	(2.6)
Interest received	0.2	1.3	1.4	2.7	4.6
Tax paid	(3.9)	(22.5)	(52.3)	(63.2)	(73.7)
Others					
Net operating CF	**83.8**	**163.9**	**187.3**	**252.0**	**298.8**
Capex	(60.8)	(67.1)	(75.0)	(50.0)	(100.0)
Disposals	0.1	0.3	0.0	0.0	0.0
Others	(0.1)	0.0	0.0	0.0	0.0
Net investing CF	**(60.9)**	**(66.7)**	**(75.0)**	**(50.0)**	**(100.0)**
Dividend	(8.5)	(44.8)	(64.8)	(78.3)	(91.3)
Drawdown	36.3	0.0	0.0	0.0	0.0
Repayment	(22.2)	(14.7)	0.0	0.0	0.0
Others					
Net financing CF	**5.6**	**(59.5)**	**(65.4)**	**(78.7)**	**(92.1)**
Net change	28.6	37.6	46.9	123.3	106.7
Forex	1.2	(1.2)	0.0	0.0	0.0
Cash brought forward	**8.3**	**38.2**	**74.6**	**121.5**	**244.8**
Cash carried forward	**38.2**	**74.6**	**121.5**	**243.1**	**351.5**

Source: CLSA Asia-Pacific Markets

Peers comparison

Keeping its lead

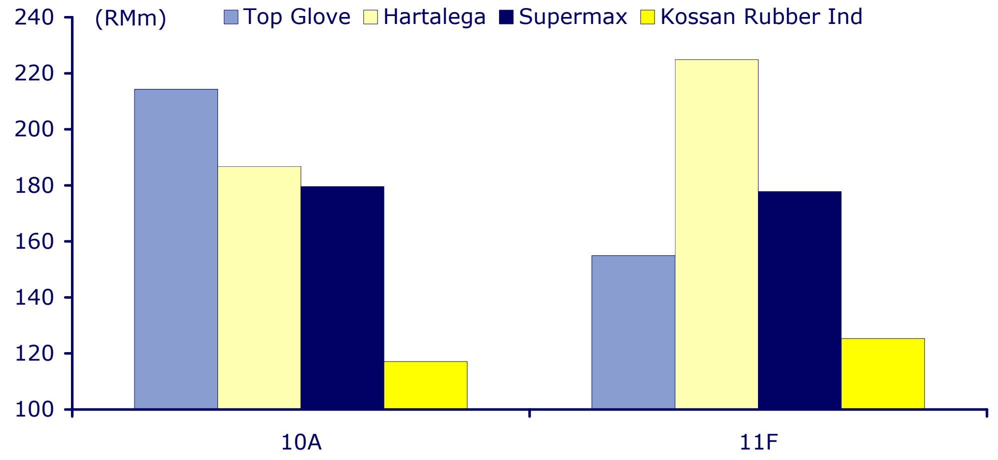
Hartalega is the only glove manufacturer that looks likely to register double-digit growth in the next two years and maintain its pole position in terms of ROE and net-profit margins. Moreover, we expect Hartalega to maintain its lead against the industry in terms of profitability into 2011. Therefore, we believe it should trade in line with Top Glove's historical average PE of 12x.

We see little justification for Hartalega to trade at a discount to its peers in view of its rising earnings and top-of-the-group margins. Based on its 11CL and 12CL PEs, it is now trading at a 18-22% discount to its peers.

Hartalega to lead on profits

Figure 53

Net profit



Source: IBES, CLSA Asia-Pacific Markets

Figure 54

Peers comparison (Calendar)

	Price LC	Mkt cap (US$bn)	ADT (US$m)	TP LC	Rec	Core EPS growth (%)		Core PE (x)		PB (x)		NP margin (%)	ROE (%)
						11CL	12CL	11CL	12CL	11CL	12CL	11CL	11CL
Top Glove	5.29	1.1	2.0	4.60	U-PF	(27.7)	36.0	20.7	15.2	2.6	2.4	5.8	17.0
Hartalega	5.54	0.7	0.7	7.40	BUY	20.4	17.0	9.0	7.7	3.2	2.5	26.1	36.2
Supermax[1]	4.40	0.5	2.0	-	-	(0.2)	10.6	8.1	7.3	1.7	1.5	15.0	24.2
Kossan[1]	3.19	0.3	0.5	-	-	7.6	9.3	8.1	7.4	1.9	1.5	10.2	26.3
Average						**0.0**	**18.2**	**11.5**	**9.4**	**2.4**	**2.0**	**14.3**	**25.9**
Average (ex-Harta)						**(6.8)**	**18.7**	**12.3**	**10.0**	**2.1**	**1.8**	**10.3**	**22.5**

[1] IBES, Source: CLSA Asia-Pacific Markets

Management and corporate governance

A well-run family business

Hartalega is a family-owned entity with a committed family-based team. The owners are highly dedicated and involved in the day-to-day operations. We believe management will ensure continuous business improvements leveraging on its core strength: R&D and process engineering.

The chairman, Kuan Kam Hon started Hartalega in 1988, and has accumulated strong industry knowledge. We see limited corporate governance (CG) issues and a good level of transparency. Access to management and guidance has been forthcoming.

To quantify the company's CG risk profile, we compile a CG score based on seven key categories: discipline, transparency, independence, accountability, responsibility, fairness and our Clean & Green (C&G) survey. Under each of these categories, we assess companies on issues that are important to constituting good corporate practices. Hartalega's CG score is 56, which ranks it 28 out of 75 companies assessed in healthcare sector. Hartalega rated poorly on accountability and independence due to a lack of "independent and non-executive" persons on the board. We view other elements of the assessment are within acceptable levels.

Risks

Latex price see a significant drop would reverse our thesis

Latex versus nitrile: The biggest risk to our thesis is a substantial drop to latex prices to below RM8/kg. This would result in prices of natural rubber gloves being at par with nitrile gloves, assuming current nitrile prices remain constant. If there is breach of the pricing rule of thumb, this would result in a reversal of the favourable pricing environment for nitrile.

Sustained demand is important for thesis

Demand versus supply: At equilibrium, the industry would be able to pass 70-80% of a change in costs on to customers. If the supply of nitrile gloves outpaces demand, we could see active pricing strategies that would be negative for margins. Of late, a few industry players have started increasing production of nitrile gloves following the increase in demand. Should nitrile gloves continue to be priced at a discount to natural rubber gloves, we see limited risk of an oversupply in the short term. Most importantly, Hartalega should be able to stay ahead of competitors due to its first-mover advantage.

Major customers: About 40% of Hartalega's sales are to two major customers. This exposes Hartalega to increased customer risks. Nonetheless, this ratio has declined from 50% on the back of a broadening customer base.

Hartalega is in a sweetspot

Figure 55

SWOT analysis

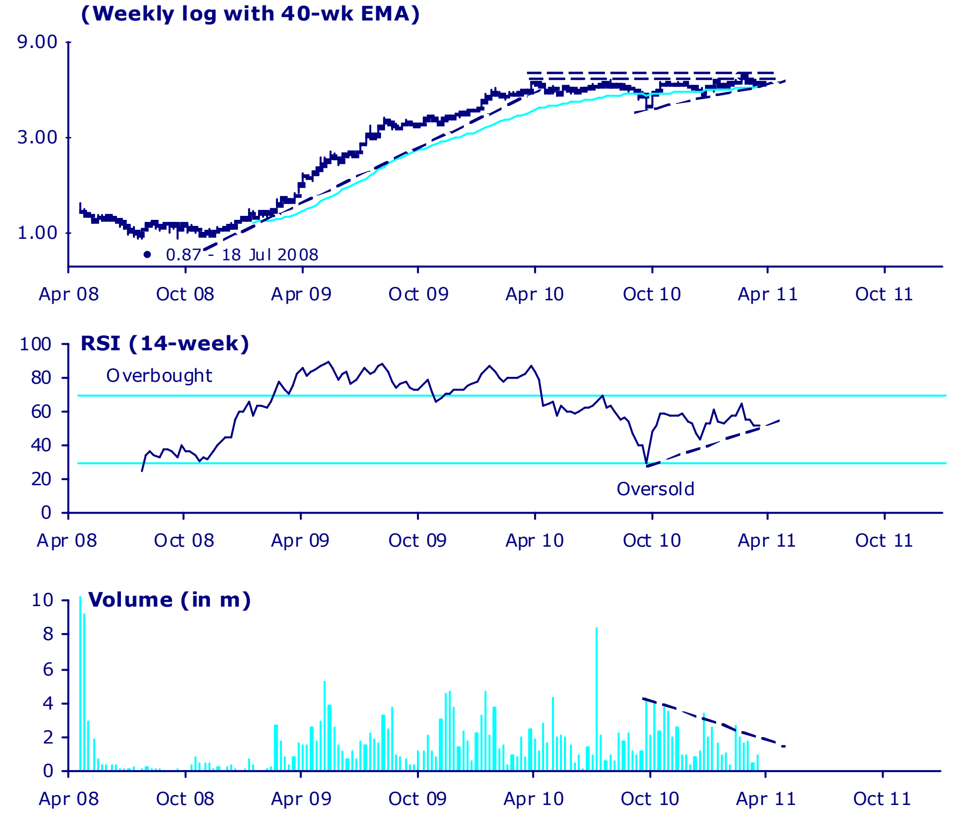
Strengths	Weaknesses
❑ Hartalega decision to concentrate on nitrile-glove manufacturing ahead of its peers gives it a first-mover advantage. ❑ Focus on R&D and process engineering allows for continuous product innovation with automation capability, which is 10 years ahead of competitors. ❑ Nitrile feedstock is also less volatile than latex.	❑ Product mix is concentrated on a single item; nitrile gloves, making it vulnerable should there be a change in trend.
Opportunities	**Threats (Risks)**
❑ In a high latex price environment, there has been rising demand for nitrile gloves due to its cheaper price compared to natural rubber gloves. ❑ Nitrile gloves have also seen increased demand coming in from the US and Western Europe; structural shift.	❑ If latex prices should drop, the price of rubber gloves would become cheaper than nitrile and some consumers might switch back to natural rubber gloves.

Source: CLSA Asia-Pacific Markets

Overhead resistance of RM5.70-6.08 has stalled the stock's strong uptrend from July-2008 lows that includes its all-time high reached this February. Evident on its weekly chart is an ascending triangle (a continuation pattern) that has developed since the September-2010 low of RM4.04. A break above the cited resistance of RM5.70-6.08, coupled with an expansion in volume will confirm our bullish outlook on the stock. And with the RSI recovering from oversold levels, an acceleration to the upside is likely in the coming weeks, with minimum upside target of around RM7.5-8.00. A break below the September-2010 low of RM4.04 will derail the uptrend

Appendix 1: What the charts say

Hartalega weekly with 40-week WMA



Source: CLSA Asia-Pacific Markets

These views are based on technical analysis and may or may not be in agreement with the 'fundamental' view.

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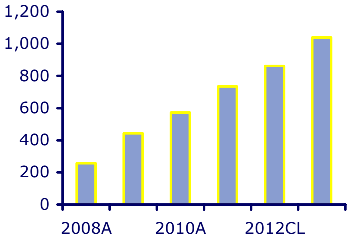
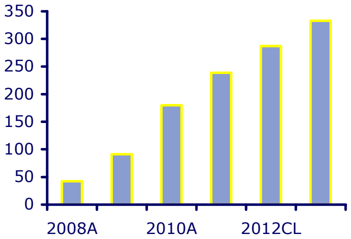
Appendix 2: Risks & drivers

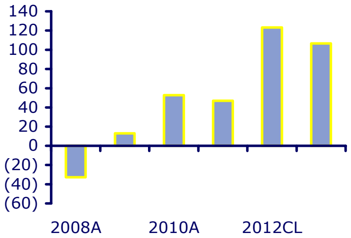
Sales (RMm)



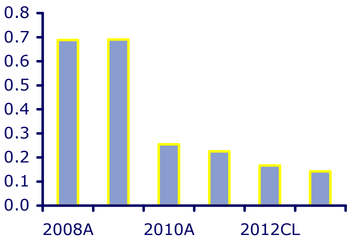
Op profit (RMm)



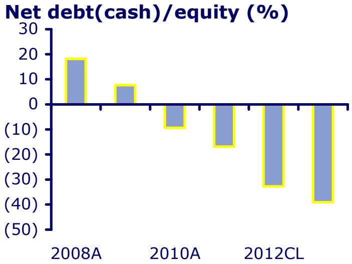
Net cashflow (RMm)



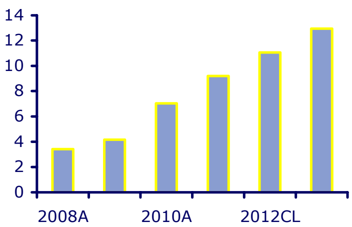
Debt coverage (years)



Net debt(cash)/equity (%)



Earnings yield (%)



Investment by numbers

Revenue will continue to increase with rising volume sales. We have assumed a further increase of 20-30% in demand for the company's nitrile gloves in FY11-13CL after an 84% Cagr in the past five years (2005-10). ASP is also set to increase as it would be able to pass along any rise in costs consistent with industry practice of 70-80% pass-through.

We expect 23% earnings Cagr for FY11-13CL on stronger demand and see margins stabilising despite rising competition. We believe Hartalega will be able to maintain its superior margins through efficient improvements and technological advances in processing methods, as well as product development to achieve similar or better quality at a lower cost.

Hartalega will continue to a see rising cash position from its already healthy balance sheet with a net cash position of RM0.24 per share. We see the net cash position rising to RM0.85 per share by FY12 assuming a consistent payout ratio of 35% and capex of RM50-100m per annum. Hartalega has seen positive and rising FCF since FY09 and should see FCF go from RM23m in FY09 to about RM200m in FY12/13CL.

Risks to our view

Latex vs nitrile: The biggest risk to our thesis is a substantial drop in latex prices to below RM8/kg. This would result in natural rubber gloves being priced at par to nitrile gloves, assuming the current nitrile price remains constant. If there is breach of the rule of thumb that "if latex prices are more than double nitrile, natural rubber gloves will be more expensive than nitrile gloves", this would result in a reversal of the favourable pricing environment for nitrile.

Demand versus supply: At equilibrium, the industry would be able to pass 70-80% of a change in costs on to customers. If the supply of nitrile gloves outpaces demand, we could see active pricing strategies that would be negative for margins.

Major customers: About 40% of Hartalega's sales are to two major customers. This exposes Hartalega to increased customer risks. Nonetheless, this ratio has declined from 50% on the back of a broadening customer base.

Key earnings drivers

Year to 31 March	2009A	2010A	2011CL	2012CL	2013CL
Volume growth (%)	41.1	38.2	21.9	27.4	18.7
ASP (US$/1,000 gloves)	33.8	31.3	36.2	35.7	37.0
RM/USD (Average)	3.43	3.46	3.15	2.95	2.88
Nitrile (US$/kg)	1.36	1.02	1.22	1.15	1.28
Latex (RM/kg)	5.24	5.20	8.50	10.16	10.62
Average cost (US$/1,000 gloves)	20.29	14.08	16.02	15.36	16.43

Appendix 3: Summary financials

Year to 31 March	2009A	2010A	2011CL	2012CL	2013CL
Summary P&L forecast (RMm)					
Revenue	**443**	**572**	**735**	**863**	**1,039**
Op Ebitda	107	200	268	319	371
Op Ebit	91	180	239	287	333
Interest income	0	1	3	4	7
Interest expense	(2)	(3)	(3)	(3)	(3)
Other items	6	0	0	0	0
Profit before tax	**95**	**178**	**240**	**289**	**338**
Taxation	(11)	(35)	(53)	(63)	(74)
Minorities/Pref divs	0	0	0	0	0
Net profit	**85**	**143**	**187**	**225**	**263**
Summary cashflow forecast (RMm)					
Operating profit	**91**	**180**	**239**	**287**	**333**
Operating adjustments	0	0	0	0	0
Depreciation/amortisation	16	20	29	32	38
Working capital changes	(23)	(15)	(29)	(5)	(2)
Net interest/taxes/other	0	(22)	(55)	(66)	(77)
Net operating cashflow	**84**	**163**	**184**	**248**	**292**
Capital expenditure	(61)	(67)	(75)	(50)	(100)
Free cashflow	**23**	**96**	**109**	**198**	**192**
Acq/inv/disposals	0	0	0	0	0
Int, invt & associate div	0	1	3	4	7
Net investing cashflow	**(61)**	**(65)**	**(72)**	**(46)**	**(93)**
Increase in loans	14	(15)	0	0	0
Dividends	(8)	(45)	(65)	(79)	(92)
Net equity raised/other	0	0	0	0	0
Net financing cashflow	**6**	**(60)**	**(65)**	**(79)**	**(92)**
Incr/(decr) in net cash	**29**	**38**	**47**	**123**	**107**
Exch rate movements	1	(1)	0	0	0
Opening cash	**8**	**38**	**75**	**122**	**245**
Closing cash	**38**	**75**	**122**	**245**	**352**
Summary balance sheet forecast (RMm)					
Cash & equivalents	38	75	122	245	352
Debtors	66	83	107	125	151
Inventories	25	28	45	39	32
Other current assets	0	0	0	0	0
Fixed assets	246	293	339	357	419
Intangible assets	0	0	0	0	0
Other term assets	0	0	0	0	0
Total assets	**375**	**479**	**612**	**766**	**953**
Short-term debt	15	14	14	14	14
Creditors	36	44	56	64	80
Other current liabs	2	11	11	11	11
Long-term debt/CBs	43	28	28	28	28
Provisions/other LT liabs	25	28	28	28	28
Minorities/other equity	0	0	0	1	1
Shareholder funds	254	354	475	622	793
Total liabs & equity	**375**	**479**	**612**	**766**	**953**
Ratio analysis					
Revenue growth (% YoY)	72.1	29.0	28.5	17.4	20.4
Ebitda growth (% YoY)	106.7	86.9	34.1	19.1	16.2
Ebitda margin (%)	24.1	34.9	36.4	37.0	35.7
Net profit margin (%)	19.1	25.0	25.4	26.1	25.3
Dividend payout (%)	34.4	33.9	35.0	35.0	35.0
Effective tax rate (%)	11.5	19.5	22.0	22.0	22.0
Ebitda/net int exp (x)	48.0	95.0	0.0	0.0	0.0
Net debt/equity (%)	7.7	(9.4)	(16.9)	(32.7)	(39.1)
ROE (%)	38.9	47.0	45.0	41.0	37.2
ROIC (%)	30.5	44.7	48.2	51.5	54.2
EVA®/IC (%)	19.9	34.2	37.7	41.0	43.7

Source: CLSA Asia-Pacific Markets

Rising revenue on higher demand for nitrile glove

Strong pricing power and cost efficiency ensure margin preservation

More than sufficient operating cashflow to cover capex requirement

Rising cash position with strong FCF

Balance sheet strength suggests better capital management potential and possible M&A

Notes

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