


**AmResearch**
**17 April 2013**

# RUBBER GLOVES

*A look at raw material prices*
**OVERWEIGHT**

(Maintained)

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*Rationale for report : Sector update*

- We are retaining our OVERWEIGHT recommendation on the rubber gloves sector following recent reports reaffirming the trend of low and stable natural rubber (NR) and nitrile (NBR) prices (~55% of costs) in 2013. We believe that soft input costs coupled with the trend for thinner gloves will lead to lower glove prices, spurring demand (2013: +10%-15%).
- Last year, Malaysia's rubber glove exports (63% of world market share) climbed 15% (2011: -4.5%) on the back of a 6% decrease in ASPs (2011: +15%). We anticipate a similar trend in 2013 with a 12% rise in volumes translating into an average sector earnings growth of 17% (2012: 24%). This excludes any potential surge in demand should the current H7N9 outbreak escalate into a global pandemic.
- We gather that NR prices are expected to remain depressed this year as global output looks to surpass consumption, a third consecutive year of surplus. Higher yields from huge replantings in 2008-2011 and growing output contributions from Vietnam (2013: +5.5% YoY) will, amongst others, boost NR production by 4%-5% this year. Additionally, inventories in Qingdao, China's main import hub, have also soared to an all-time high of 366,900 tonnes.
- Last week, the International Tripartite Rubber Council concluded its Asean Plus 2013 Rubber Conference with no announcements on measures it intends to take to prop up NR prices. This unexpected gesture resulted in a MTD pullback in latex prices of 5.5%. We understand that further discussions will be held at its next meeting in Indonesia in May 2013.
- Although NR gloves are still a key segment (2012: 54% of exports), the trend is towards synthetic gloves (2012: 46% vs. 2011's 42%), whereby NBR input costs have also been on a downward trend, hovering at US\$1,330/tonne in March 2013. Prices slipped 24% YoY and are flat YTD mainly due to additional naphtha crackers being commissioned (16 new plants this year) on top of low utilisation rates at existing plants (65%-75%).
- We do not anticipate a resumption of stronger global NR and NBR demand growth in 2013 as recovery in the global auto sector remains subdued and the European debt crisis lingers on. China, the world's largest rubber consumer (34% of global demand), will aim to draw down its high stock levels and has said that its tyre output may only rise 4% this year in contrast to the average rate of 8.4% a year between 2007 and 2011. In addition, North American truck build slots for 2Q13 remain 41% unfilled (2Q12: 28%).
- To put things into perspective, our back-of-envelope calculations indicate that for every 10 sen decline in NR prices, sector earnings would on average rise by 5%, led by Top Glove at 8%. Meanwhile, a USD100 decline in NBR prices would see Hartalega benefit the most, with a 9% jump in earnings. Despite that, we expect sector EBITDA margins to expand a meagre 1-2 ppts, constrained by delays in plant automations and time lag from cost pass-through.
- At present, we are maintaining our FY13F-FY15F estimates, of which we have incorporated price assumptions of RM6.50/kg for NR and USD1,400/tonne for NBR. Our slightly more conservative NR price assumption reflects our view of a possible short-term price intervention by the tripartite.
- We continue to like Top Glove (BUY, FV: RM6.50/share) for its well-executed volume strategy and Kossan (BUY, FV: RM4.60/kg) for its relatively cheap valuations (PE of 10x vs. sector's 14x). In addition, these 2 groups are better-positioned to capture any sudden hike in demand for healthcare products as a result of the H7N9 bird flu. While the former has additional capacities at its plants (current utilisation rate of 60%-70%), the latter has exposure in the Chinese face masks market. Supermax and Hartalega are HOLDs with fair values of RM2.15/share and RM5.10/share, respectively.

**TABLE 1: SECTOR VALUATION MATRIX**

Company	Rating	Fair Value (RM)	Last Price (RM)	Market Cap (RM mil)	EPS (sen)			P/E (x)			P/BV (x)		ROE (%)		EPS Growth (%)			Div Yield (%)	
					FY13F	FY14F	FY15F	FY13F	FY14F	FY15F	FY13F	FY14F	FY13F	FY14F	FY13F	FY14F	FY15F	FY13F	FY14F
Top Glove	BUY	6.50	5.87	3,636.0	34.4	36.2	38.4	17.1	16.2	15.3	2.7	2.5	16.2	15.7	5.1	5.4	6.0	2.9	3.1
Kossan	BUY	4.60	3.64	1,159.8	36.9	41.2	49.5	9.9	8.8	7.4	1.7	1.5	17.7	17.2	12.9	11.6	20.3	2.7	3.0
Hartalega	HOLD	5.10	5.13	3,761.9	28.2	37.3	47.2	18.2	13.7	10.9	5.5	4.4	33.2	35.8	12.6	32.5	26.5	2.5	3.3
Supermax	HOLD	2.15	2.00	1,358.3	22.0	24.8	27.3	9.1	8.1	7.3	1.4	1.3	16.3	16.5	23.0	12.6	10.2	3.4	3.9
Simple average					30.4	34.9	40.6	13.6	11.7	10.2	2.8	2.4	20.9	21.3	13.4	15.5	15.7	2.9	3.3

Source: Company, AmResearch

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## MAINTAIN OVERWEIGHT ON BRIGHT PROSPECTS

### Lower ASPs to buoy demand

We are retaining our OVERWEIGHT recommendation on the rubber gloves sector following recent reports reaffirming the trend of low and stable natural rubber (NR) and nitrile (NBR) prices (~55% of costs) in 2013.

We believe that soft input costs coupled with the trend for thinner gloves will lead to lower glove prices, spurring demand (2013: +10%-15%).

Last year, Malaysia's rubber glove exports (63% of world market share) climbed 15% (2011: -4.5%) on the back of a 6% decrease in ASPs (2011: +15%).

We anticipate a similar trend in 2013 with a 12% rise in volumes translating into an average sector earnings growth of 17% (2012: 24%). This excludes any potential surge in demand should the current H7N9 outbreak escalate into a global pandemic.

**TABLE 2: EXPORTS BY MATERIAL TYPE (VOLUME)**

	Volume (mil pcs)			
	2009	2010	2011	2012
Natural Rubber	25,375	25,577	20,594	22,084
Synthetic Rubber	7,303	11,494	14,825	18,624
Total	32,678	37,071	35,419	40,708

	Volume breakdown (%)			
	2009	2010	2011	2012
Natural Rubber	77.7	69.0	58.1	54.2
Synthetic Rubber	22.3	31.0	41.9	45.8
Total	100.0	100.0	100.0	100.0

Source: MREPC

**TABLE 3: AVERAGE PRICES OF GLOVES (RM)**

			2009	2010	2011	2012
NR	Powdered	Examination	0.147	0.138	0.189	0.166
		Surgical	0.499	0.514	0.592	0.587
	Powder Free	Examination	0.193	0.203	0.242	0.218
		Surgical	1.072	1.031	1.108	1.140
SR	Powdered	Examination	0.238	0.212	0.231	0.203
		Surgical	0.614	0.623	0.745	no exports
	Powder Free	Examination	0.223	0.202	0.223	0.203
		Surgical	1.804	1.542	1.630	1.596

Source: MREPC

### H7N9 virus a sector catalyst

The local dailies quoted Top Glove Corp's chairman, Tan Sri Lim Wee Chai as saying that demand for gloves could potentially rise by two or three-fold in certain countries, if the H7N9 does become an epidemic.

The last 3 outbreaks/pandemics (2003: SARS; 2007: H5N1 avian flu; 2009: H1N1 swineflu) saw worldwide glove demand rise by between 11% and 24% in the year they occurred.

### Queries but no orders yet

Feedback obtained from industry players has revealed a sense of urgency with regard to order fulfillment among their customers. However, at such an early stage, they are still holding out from raising their orders. This corresponds with Mr Lim Kwee Shyan's (president of the Malaysian Rubber Glove Manufacturers Association) statement that customers, especially from the developed countries, are currently more eager to ensure future supplies than to negotiate for prices.

To date, 63 people have been infected, including 14 who have died. Whilst the virus has spread outside Eastern China to Beijing, there has not been any confirmation of human-to-human transmission, which will make it more deadly.

## NATURAL RUBBER PRICES MUTED

We gather that NR prices are expected to remain depressed this year as global output looks to surpass consumption. Nearly all rubber-watch groups agree that the rubber market will be in surplus in 2013 for the third year in a row.

### Production to grow 4%-5% in 2013

Higher yields from huge replantings in 2008-2011 and growing output contribution from Vietnam (2013: +5.5% YoY) will, amongst others, boost NR production by 4%-5% this year.

An additional overhang comes from Thailand's domestic reserves (reported to be 200,000 tonnes) following its ~US\$1bil rubber purchase programme in 2012, although an official was quoted as saying that it had no intention to offload the inventories yet.

### Reserves at peaks

Furthermore, world stockpiles at key import countries remain elevated. Inventories in Qingdao, China's main import hub, have soared to an all-time high of 366,900 tonnes, while globally, inventories were at a 7-year high of 2 million tonnes at end-2012. This would be sufficient to fulfill North American demand for 2 years.

The Rubber Economist stated that stock-to-consumption ratio will rise to 2.2 months in 2014 from 1.2 months recorded in early 2012.

TABLE 4: NR SUPPLY AND DEMAND ('000 TONNES)

	2010	2011	2012	2013	2014
Supply *	10,428	11,031	11,383	11,623	12,082
Demand	10,806	10,981	10,924	11,450	11,947
Balance	(378)	50	459	173	135
Stocks #	1,373	1,423	1,882	2,055	2,190

\* includes International Natural Rubber Organisation (INRO) stockpile disposals after 1999

# global closing stocks, year-end

Source: IRSG, EIU, Bloomberg

TABLE 5: NR STOCKS ('000 TONNES)

Quarter	2011	2012	2013	2014	2015
1Q	1,409	1,423	1,875	2,000	2,015
2Q	1,167	1,353	1,900	2,125	1,900
3Q	1,270	1,707	1,950	2,100	-
4Q	1,423	1,882	2,055	2,190	-

Source: IRSG, EIU, Bloomberg

the past 5 years, YTD April prices have jumped 18% mainly due to the wintering season.

Following this, the chairman of the Rubber Association of Indonesia had said that NR producers should focus on managing supplies from rubber plantations instead of capping shipments. Although Malaysian officials have reportedly concurred, Thai authorities are on the contrary. It had earlier this month proposed to extend its export reductions to end of May 2013.

Traditionally, these countries have resorted to cutting down rubber trees to support prices.

#### □ *Auxiliary discussions next month*

We understand that further discussions will be held at its next meeting in Indonesia in May 2013.

Topics to be tabled include:- (1) NR price trends; (2) global rubber production and consumption; (3) replanting considerations; and (4) ways to minimise price gaps between shipments.

According to *Bangkok Post*, Indonesia's rubber is at present the cheapest among the tripartite members, shipping at discounts of USD0.30/kg to Thailand's and USD0.15/kg to Malaysia's.

## TRIPARTITE TALKS INCONCLUSIVE

### □ *No measures announced, prices retrace*

Last week, the International Tripartite Rubber Council concluded its Asean Plus 2013 Rubber Conference whereby representatives from the top three rubber producing countries (Thailand, Indonesia and Malaysia) discussed measures to prop up prices.

Despite the market's anticipation of a tripartite announcement on some form of price support, including the possible extension of export limits, none were made, resulting in a MTD pullback in latex prices of 5.5%.

### □ *Previous agreed upon 300,000 tonnes successfully reduced*

The tripartite did, however, declare that its targeted export reduction of 300,000 tonnes (3% of global production) for the six months to March 2013 under the Agreed Export Tonnage Scheme (AETS) was achieved.

### □ *Measure may not be repeated due to lack of effect*

Nonetheless, as we have noted in our earlier reports, the impact on NR prices was negligible. The average NR price in October 2012 was up 5% MoM, when the AETS was implemented, only to decline by 9% in November 2012.

YTD, the Malaysian bulk latex prices have dropped 4%, with its April 2013 average of RM5.92/kg the lowest in 3 years. In

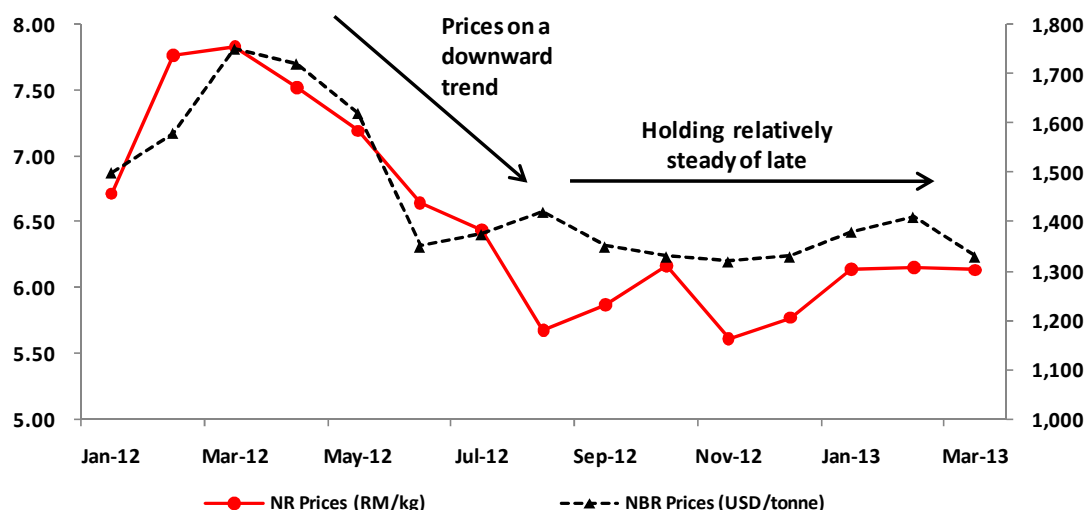
## NITRILE PRICES DECLINING, TOO

Although NR gloves are still a key segment (2012: 54% of exports), the trend is towards synthetic gloves (2012:46% vs. 2011's 42%), whereby NBR input costs have also been on a downward trend, hovering at US\$1,330/tonne in March 2013.

Prices slipped 24% YoY and are flat YTD. The price slump is mainly due to additional naphtha crackers being commissioned (16 new plants this year) on top of low utilisation rates at existing plants (65%-75%).

Contrary to popular belief, NBR prices are less correlated with crude oil prices but moves in tandem with NR prices.

CHART 1: MONTHLY NATURAL RUBBER (NR) AND NITRILE (NBR) PRICE TRENDS



Source: MRB, Company, AmResearch

## DEMAND IN 2013 SLOW

We do not anticipate a resumption of stronger global NR and NBR demand growth in 2013 as recovery in the global auto sector (tyre industry uses 70% of global rubber production vs. glove's 12%) remains subdued and the European debt crisis lingers on.

China, the world's largest rubber consumer (34% of global demand) will aim to draw down its high stock levels and has said that its tyre output may only rise 4% this year in contrast to the average rate of 8.4% a year between 2007 and 2011.

In addition, North American truck build slots for 2Q13 remain 41% unfilled (2Q12: 28%). Truck production in the US had expanded by 8.9% YoY in 2012.

## RAW MATERIALS SENSITIVITY ANALYSIS

To put things into perspective, our back-of-envelope calculations indicate that for every 10 sen decline in NR prices, sector earnings would on average rise by 5%, led by Top Glove at 8%.

Meanwhile, a USD100 decline in NBR prices would see Hartalega benefit the most, with a 9% jump in earnings.

Despite that, we expect sector EBTIDA margins to expand a meagre 1-2 ppts, constrained by delays in plant automations and time lag from cost pass-through.

## PRICE ASSUMPTIONS STILL VALID

At present, we are maintaining our FY13F-FY15F estimates, of which we have incorporated price assumptions of RM6.50/kg for NR and USD1,400/tonne for NBR.

Our slightly more conservative NR price assumption reflects our view of a possible short-term price intervention by the tripartite.

## SECTOR PICKS

### □ *Reiterate BUY on Top Glove and Kossan...*

We continue to like Top Glove (BUY, FV: RM6.50/share) for its well-executed volume strategy and Kossan (BUY, FV: RM4.60/kg) for its relatively cheap valuations (PE of 10x vs sector's 14x).

In addition, these 2 groups are better-positioned to capture any sudden hike in demand for healthcare products as a result of the H7N9 bird flu. While the former has additional capacities at its plants (current utilisation rate of 60%-70%), the latter has exposure in the Chinese face masks market.

### □ *...and HOLDS on Supermax and Hartalega*

Supermax and Hartalega are HOLDS with fair values of RM2.15/share and RM5.10/share, respectively.

TABLE 6: NR PRODUCTION ('000 TONNES)

Country	2010	2011	2012	2013	2014
Thailand	3,252	3,394	3,512	3,658	3,841
Indonesia	2,736	2,982	3,015	3,060	3,152
Malaysia	939	996	923	954	978
India	851	893	915	920	938
Vietnam	752	812	888	932	988
China	687	727	795	827	868
Ivory Coast	231	234	255	263	276
Brazil	136	166	171	144	150
Others	844	828	909	865	891
World	10,428	11,031	11,383	11,623	12,082
Change (%)	7.6	5.8	3.2	2.1	3.9

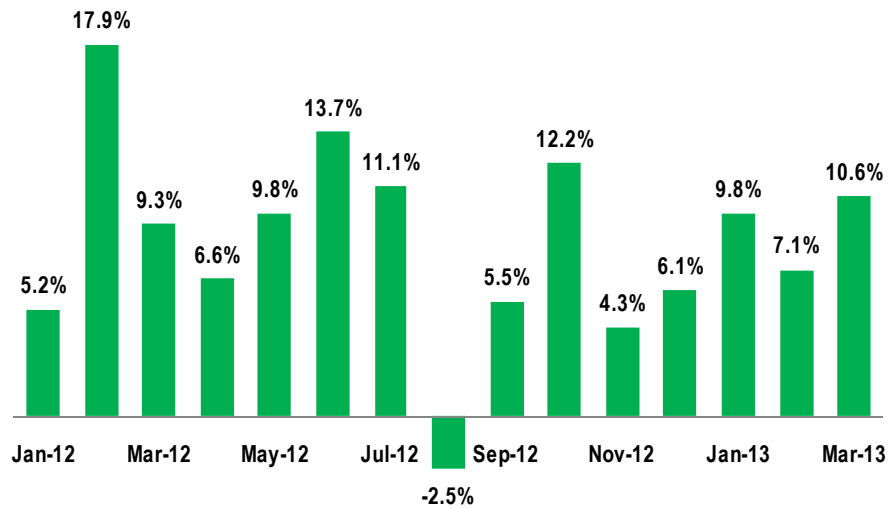
Source: IRSG, EIU, Bloomberg

TABLE 7: NR CONSUMPTION ('000 TONNES)

Country	2010	2011	2012	2013	2014
China	3,668	3,622	3,853	4,043	4,240
India	944	958	988	1,028	1,092
Japan	749	753	720	736	752
Other Asia (incl Australia)	2,292	2,296	2,354	2,437	2,534
EU	1,132	1,225	1,065	1,056	1,088
Other Europe (incl former Soviet Union)	228	251	238	280	297
North America (US & Canada)	1,071	1,173	1,088	1,115	1,143
Latin America	616	613	596	653	695
Africa	101	91	97	100	107
World	10,806	10,981	10,924	11,450	11,947
Change (%)	15.8	1.6	(0.5)	4.8	4.3

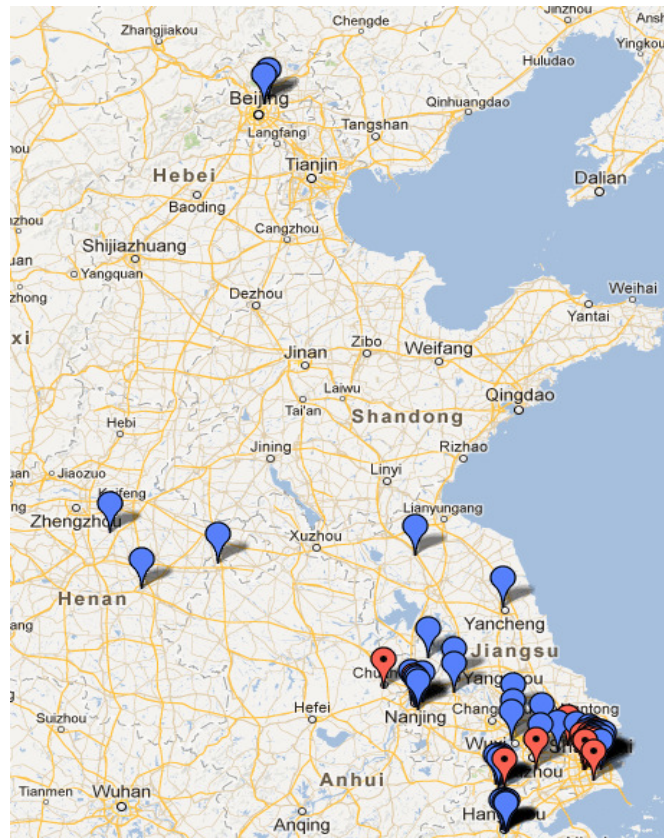
Source: IRSG, EIU, Bloomberg

CHART 2: NBR DISCOUNT/(PREMIUM) TO NR



Source: Company, AmResearch

CHART 3: H7N9 OUTBREAK LOCATIONS (AS AT 15 APRIL 2013)



Source: IRSG, EIU, Bloomberg

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Managing Director