AmResearch

Company report

HARTALEGA HOLDINGS

(HART MK, HTHB.KL) **3 May 2013**

Capacity constraints curb near-term growth

HOLD

(Maintained)

Cheryl Tan
cheryl-tan@ambankgroup.com
+603 2036 2333

Rationale for report: Company Update

Price	RM5.25
Fair Value	RM5.00
52-week High/Low	RM5.29/RM3.58

Key Changes

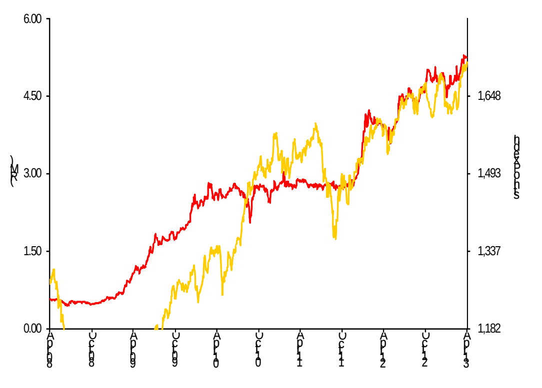
Fair value	↓
EPS	↓

YE to Mar	FY12	FY13F	FY14F	FY15F
Revenue (RMmil)	931.1	1,025.0	1,237.6	1,344.7
Core net profit (RMmil)	201.4	226.7	268.8	287.0
EPS (Sen)	25.0	28.2	33.4	35.7
EPS growth (%)	n/a	12.6	18.5	6.8
Consensus EPS (Sen)	201.6	229.4	264.1	296.0
DPS (Sen)	11.3	13.0	15.0	16.0
PE (x)	20.9	18.6	15.7	14.7
EV/EBITDA (x)	14.2	12.7	10.7	9.7
Div yield (%)	2.2	2.5	2.9	3.1
ROE (%)	36.2	33.2	32.5	29.1
Net Gearing (%)	n/a	n/a	10.3	10.5

Stock and Financial Data

Shares Outstanding (million)	804.7
Market Cap (RMmil)	4,216.6
Book value (RM/share)	0.77
P/BV (x)	6.8
ROE (%)	36.2
Net Gearing (%)	n/a
Major Shareholders	Hartalega Industries Sdn Bhd (50.2%) Budi Tenggara (5.0%)
Free Float (%)	44.8
Avg Daily Value (RMmil)	3.3

Price performance	3mth	6mth	12mth
Absolute (%)	12.9	15.1	33.4
Relative (%)	8.6	13.0	25.4



Investment Highlights

- **Following our recent company visit, we reaffirm our HOLD recommendation on Hartalega Holdings (Hartalega) with a slightly lower fair value of RM5.00/share (vs. RM5.10/share previously). Our fair value is now pegged to a PE of 15x FY14F EPS, a premium to the sector's 14x but 20% below industry proxy Top Glove's 19x.**

- **While we maintain our FY13F (Mar YE) estimates, we have cut our FY14F and FY15F earnings by 9% and 21%, respectively, to reflect:- (1) the delays in its capacity expansion plans; and (2) declining ASPs on the back of intensifying price competition.**

- **Against the backdrop of healthy global rubber glove demand (FY13F: +10%-15%), the group's expansion delays (CY13-CY14 capacity growth of 2% vs. peers' average of 3%) and current oversold position place it at a disadvantage to its peers. This is more pressing given that nitrile (NBR) gloves, of which Hartalega is the market leader at 17%, remain the key growth segment. (NBR 3-yr CAGR: +37% vs. latex:-5%).**

- **Hartalega's current installed capacity of 11bil pcs per annum (p.a.) is set to rise by 26% in FY14F and a lower 10% in FY15F. This follows an 8-month delay in the construction and commissioning (estimated August 2014) of its NGC project in Sepang, which we anticipate would result in a loss of production of 220mil pcs or a topline decline of RM23mil over both years.**

- **To mitigate this, we understand that Hartalega has ongoing plans to acquire a 25,000-acre land in Bestari Jaya to build 3 plants dedicated to the production of higher-valued specialty gloves (margins +8% above NBR gloves).**

- **While concerns about overcapacity of NBR gloves are abating, the more hostile pricing environment and declining input costs have prompted Hartalega to reduce its ASPs by 8% for FY14F to USD31/1,000pcs. Further discounts are limited by the industry's rising cost following:- (1) the implementation of the minimum wage policy (FY13F impact for Hartalega: +10%); (2) potential hike in fuel prices; as well as (3) loss of tax incentives by its peers.**

- **Nonetheless, we expect Hartalega's superior EBITDA margin to remain stable ahead at ~32% (FY12: 31%) contributed by:- (1) its high productivity and efficient operations; and (2) nitrile's intrinsic pricing advantage over latex (discount to latex of 10%).**

- **Concomitant to our FY14F-FY15F earnings cut, we have revised downwards our gross DPS forecast to 15 sen and 16 sen, respectively. Its yields of ~3% are comparable to Top Glove's but 1ppt below Kossan's and Supermax's.**

- **Hartalega is set to release its FY13 results on May 7. We believe our FY13 earnings estimate of RM227mil (+13% YoY) will be met, supported by:- (1) favourable NBR input prices (-24% YoY); and (2) healthy +24% YoY growth in volume sales.**

PP 12247/06/2013 (032380)

REAFFIRM HOLD, LOWER FAIR VALUE

Following our recent company visit, we reaffirm our HOLD recommendation on Hartalega Holdings (Hartalega) with a slightly lower fair value of RM5.00/share.

Our fair value is now pegged to a PE of 15x FY14F EPS, a premium to the sector's 14x but 20% below industry proxy Top Glove's 19x.

❑ *Share price rises in-line with sector's*

YTD, Hartalega's share price has done well, in-line with the upward trend of the other rubber glove counters. The stock and sector, on average, has outperformed the FBM KLCI by 9ppts.

While the surge in the past month was mostly due to speculative behaviour spurred by the H7N9 bird flu outbreak, we reckon that the defensive nature and growth prospects of the industry as well as strong company fundamentals have also played a role.

However, we do caution that share prices may retrace should the H7N9 bird flu not escalate into an actual pandemic as had been widely expected.

FY14F-FY15F EARNINGS CUT

While we maintain our FY13F (Mar YE) estimates, we have cut our FY14F and FY15F earnings by 9% to RM269mil and 21% to RM287mil, respectively, to reflect:- (1) the delays in its capacity expansion plans; and (2) declining ASPs on the back of intensifying price competition.

Hartalega is set to release its FY13 results on May 7. We believe our FY13 earnings estimate of RM227mil (+13% YoY) will be met, supported by:- (1) favourable NBR input prices (-24% YoY); and (2) healthy +24% YoY growth in volume sales.

HANDICAPPED BY PRODUCTION CONSTRAINTS

❑ *Healthy global glove demand*

Against the backdrop of healthy global rubber glove demand (FY13F: +10%-15%), the group's expansion delays and current oversold position place it at a disadvantage to its peers.

TABLE 1: EXPORTS BY MATERIAL TYPE (VOLUMES)

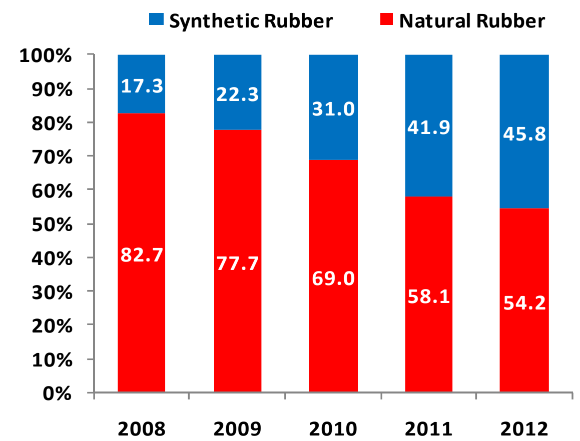
	Volume (mil pcs)			
	2009	2010	2011	2012
Natural Rubber	25,375	25,577	20,594	22,084
Synthetic Rubber	7,303	11,494	14,825	18,624
Total	32,678	37,071	35,419	40,708

Source: MREPC, AmResearch

❑ *Nitrile gloves to lead the way*

This is more pressing given that nitrile (NBR) gloves, of which Hartalega is the market leader at 17%, remain the key growth segment. (NBR 3-yr CAGR: +37% vs. latex:- 5%). According to MREPC's 2012 report, nitrile gloves comprise 46% of rubber glove exports, more than double that in 2009 (22%).

CHART 1 : BREAKDOWN OF MALAYSIAN RUBBER GLOVE EXPORT BY MATERIAL



Source: MREPC, AmResearch

❑ *Competition closing in*

Note that the other top three glove manufacturers, namely Top Glove Corp, Kossan Rubber Industries and Supermax Corp, have been aggressively expanding into this segment since 2011. Together, they have added close to 10bil pcs of NBR gloves in the past 2 years and are embarking on expansion plans for another 11bil pcs by Dec 2013. Meanwhile, Hartalega's capacity growth of 2% for CY13-CY14 is 1ppt behind that of its major competitors.

To paint a clearer picture, Top Glove, who was a late-entrant into the nitrile segment, will have a NBR glove capacity of 12bil pcs by April 2014. This is comparable to Hartalega's 14bil pcs p.a. by FY14F.

❑ *Can it capitalise on H7N9 threat?*

Management did indicate that should rubber glove demand grow exponentially following the H7N9 bird flu threat being declared a pandemic, Hartalega has the ability to ramp up its capacity utilisation to 95% (from 88% currently) to produce a further 500mil pcs p.a.

DISRUPTED EXPANSION PLANS

At present (FY13F), Hartalega has an installed capacity of 11 bil pcs per annum (p.a.). This is set to rise by 26% in FY14F as the final 3 (out of 10) lines from Plant 6 are commissioned by July 2013, and a slower 10% in FY15F to reach 15bil pcs p.a.

- ***Growth stunted by NGC***

The passive growth in the latter can be mainly attributed to the delay in the construction of its Next Generation Integrated Glove Manufacturing Complex (NGC) in Sepang as relevant approvals from authorities have been held up.

With commissioning being pushed back by ~8 months to August 2014, we anticipate a loss in production of 220mil pcs, which translate into a topline decline of RM23mil over both years, with the bulk in FY15F.

Recall, the NGC project is a RM1.5-RM1.9bil, 8-year investment to build 7 plants with 10 lines each to raise Hartalega's installed capacity by 24.4bil pcs p.a. announced a year ago. Construction was scheduled to begin in 1H2013 with commissioning beginning in January 2014.

In its latest update, however, management has indicated that construction will begin in 2H2013 and 6 plants with 12 lines each will be built. Coupled with the group's technological capabilities, the projected installed capacity is raised to 28.5bil pcs p.a., bringing Hartalega's FY2023 total installed capacity to 42.5bil pcs p.a.

- ***Back-up site not needed, transformed to specialty glove plants***

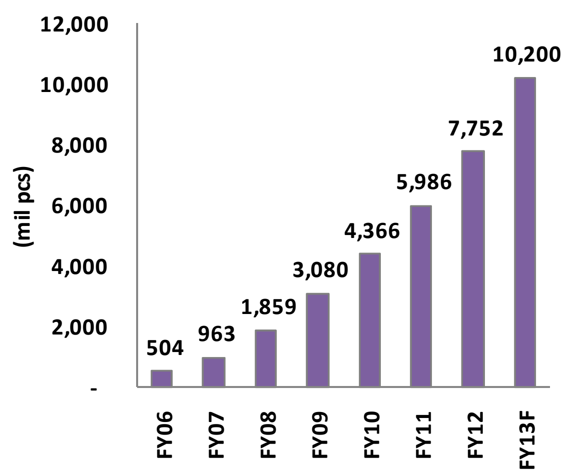
We understand that Hartalega has ongoing plans to acquire a 25,000-acre land in Bestari Jaya.

Initially slated to be a backup site for its NGC project following difficulties in procuring the 112-acre Sepang land, Hartalega now plans to build 3 plants dedicated to the production of specialty gloves.

These gloves command greater margins, 8% above that of NBR gloves and 10% over latex gloves.

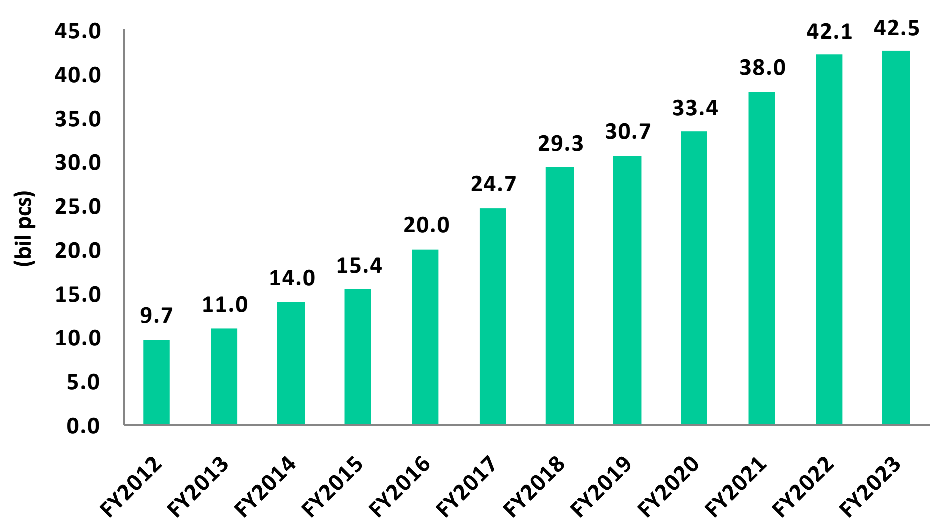
The construction of the plants will run alongside the group's NGC plans although it was to be fast-tracked earlier on.

CHART 2 : HARTALEGA'S NITRILE GLOVE SALES



Source: Company, AmResearch

CHART 3 : CAPACITY PROJECTION WITH NGC CONTRIBUTION FROM FY15F



Source: Company, AmResearch

ASPs ON A DOWNWARD TREND

❑ *ASPs to fall 8%*

While concerns about overcapacity of NBR gloves are abating, the more hostile pricing environment and declining input costs have prompted Hartalega to reduce its ASPs by 8% for FY14F to USD31/1,000 pcs. (RM105 to RM98 per thousand pcs).

❑ *Not keen on entering a price war*

Priding itself as a premium rubber glove seller and not a price competitor, management has indicated that it will not be slashing prices to gain market share.

With their higher margins and position as the lowest cost nitrile glove producer (71 cents/pc), we believe that Hartalega may still have room for a further cut of up to USD25/1,000 pcs.

❑ *Supported by higher cost floor*

We reckon that further discounting is limited by the industry's rising cost floor following:-

(1) the implementation of the minimum wage policy; The FY13F impact on wage costs for Hartalega was +10% as it had also increased its headcount by 700 workers in preparation of the NGC project.

(2) potential hike in fuel prices from a gradual subsidy pullback; as well as

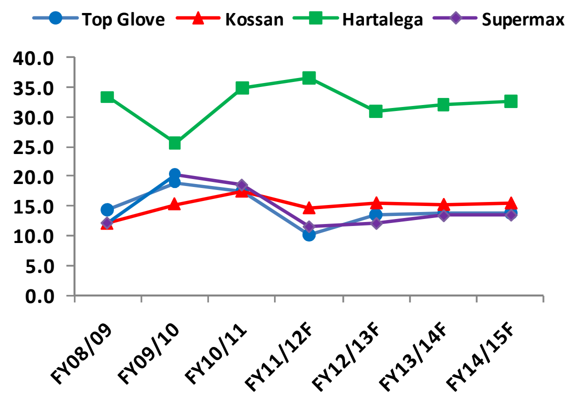
(3) loss of tax incentives by its peers. The expiry of reinvestment allowance (RA) taxes by most of the rubber glove manufacturers this year requires more prudence in ensuring they stay deeper in the black. Hartalega's effective tax rates are ~22% as it can still claim deductions from capital allowances.

EBITDA MARGINS TO REMAIN STABLE

Overall, we expect Hartalega's superior EBITDA margins to remain stable at ~32% (FY12: 31%) moving forward contributed by:- (1) the group's high productivity and efficient operations; and (2) nitrile's intrinsic pricing advantage over latex (discount to latex of 10%).

Management reckons that each additional factory potentially expands margins by ~1% as a result of automation, increased production line speed and economies of scale.

CHART 5 : EBITDA MARGINS OF GLOVE MAKERS



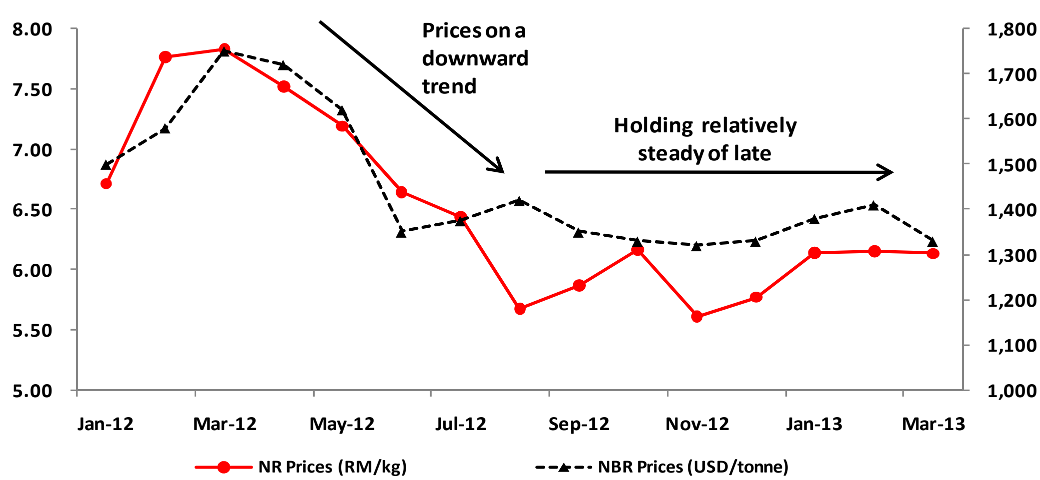
Source: Companies, AmResearch

DIVIDEND YIELDS DECENT AT 3%

Concomitant to our FY14F-FY15F earnings cut, we have revised downwards our gross DPS forecast by 12%-24% to 15 sen and 16 sen, respectively, based on a 45% payout ratio.

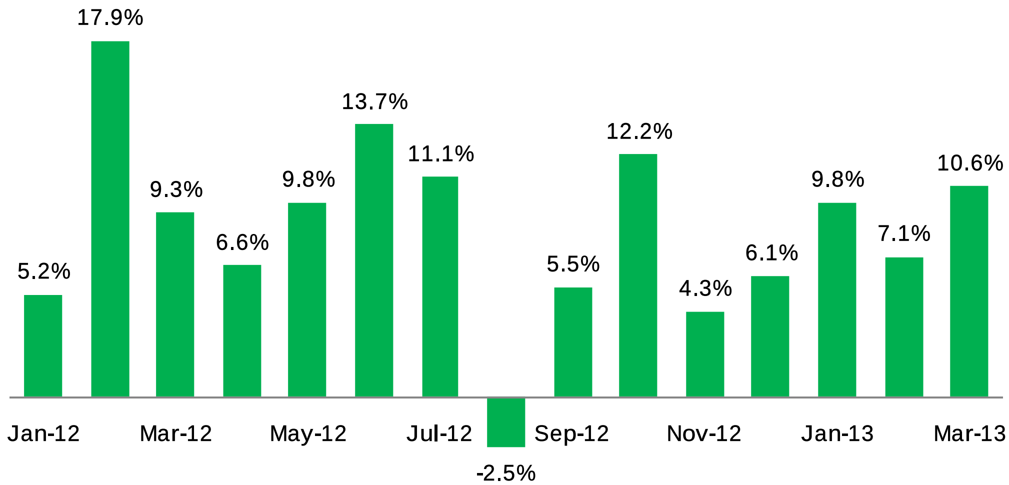
Its yields of ~3% are comparable to Top Glove's but 1ppt below Kossan's and Supermax's.

CHART 4 : MONTHLY NATURAL RUBBER AND NITRILE PRICE TRENDS



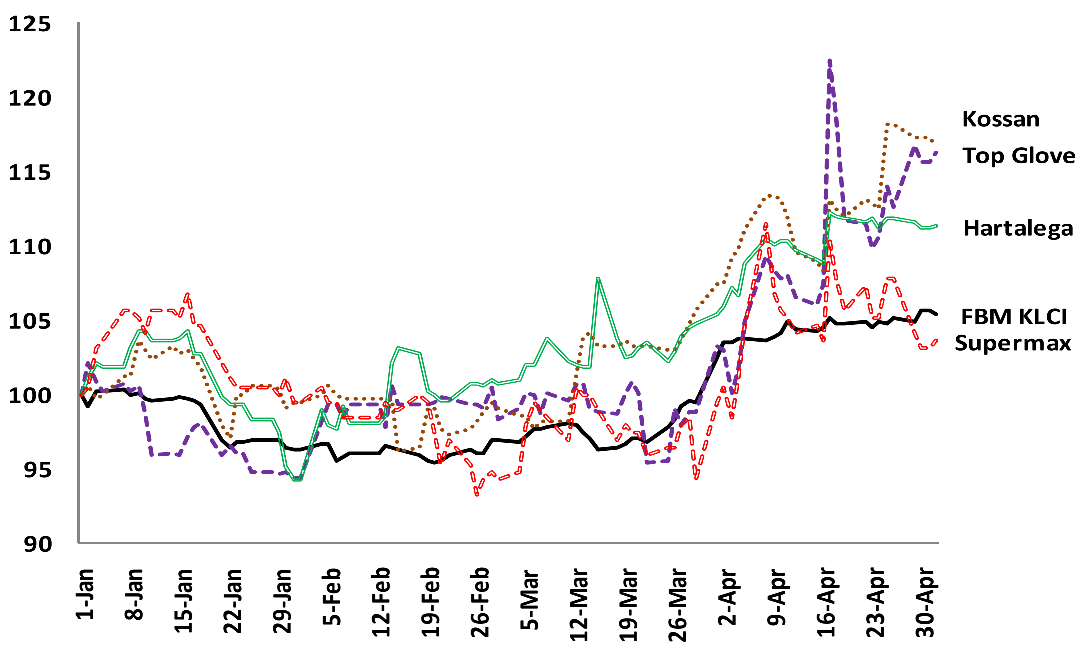
Source: Company, AmResearch

CHART 6 : NITRILE TO LATEX PRICE DISCOUNT/(PREMIUM)



Source: Company, AmResearch

CHART 7 : YTD RELATIVE PERFORMANCE OF RUBBER GLOVE STOCKS VS FBM KLCI



Source: Bloomberg, AmResearch

CHART 8 : PB BAND CHART

CHART 9 : PE BAND CHART

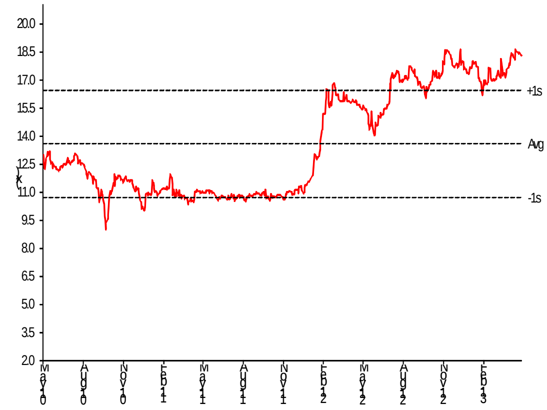


TABLE 2: FINANCIAL DATA

Income Statement (RMmil, YE 31 Mar)	2011	2012	2013F	2014F	2015F
Revenue	734.9	931.1	1,025.0	1,237.6	1,344.7
EBITDA	268.2	288.2	328.6	402.9	448.3
Depreciation	(25.0)	(29.0)	(37.4)	(54.0)	(70.7)
Operating income (EBIT)	243.2	259.2	291.2	349	377.6
Other income & associates	0.0	0.0	0.0	0.0	0.0
Net interest	(0.4)	(0.8)	(2.4)	(6.4)	(11.9)
Exceptional items	0.0	0.0	0.0	0.0	0.0
Pretax profit	242.8	258.4	288.9	342.4	365.7
Taxation	(52.5)	(57.0)	(62.1)	(73.6)	(78.6)
Minorities/pref dividends	0.0	(0.1)	(0.1)	(0.1)	(0.1)
Net profit	190.3	201.4	226.7	268.8	287.0
Core net profit	190.3	201.4	226.7	268.8	287.0

Balance Sheet (RMmil, YE 31 Mar)	2011	2012	2013F	2014F	2015F
Fixed assets	348.6	370.3	561.4	836.2	994.2
Intangible assets	0.1	0.0	0.0	0.0	0.0
Other long-term assets	0.2	9.9	9.9	9.9	9.9
Total non-current assets	348.9	380.2	571.4	846.1	1,004.1
Cash & equivalent	117.0	163.2	152.7	124.4	222.9
Stock	64.7	97.5	107.4	132.7	149.7
Trade debtors	95.7	107.7	145.1	153.3	170.9
Other current assets	8.7	9.5	9.5	9.5	9.5
Total current assets	286.1	377.9	414.7	420.0	553.0
Trade creditors	34.4	29.5	40.7	46.6	60.4
Short-term borrowings	14.5	12.6	42.3	84.3	128.2
Other current liabilities	29.9	43.4	42.7	42.7	42.7
Total current liabilities	78.9	85.5	125.7	173.6	231.3
Long-term borrowings	24.5	12.1	72.4	144.3	219.5
Other long-term liabilities	36.9	40.5	40.5	40.5	40.5
Total long-term liabilities	61.3	52.6	112.9	184.9	260.0
Shareholders' funds	494.4	619.5	746.9	907.1	1,065.3
Minority interests	0.4	0.6	0.6	0.6	0.6
BV/share (RM)	0.68	0.77	0.93	1.13	1.32

Cash Flow (RMmil, YE 31 Mar)	2011	2012	2013F	2014F	2015F
Pretax profit	242.8	258.4	288.9	342.4	365.7
Depreciation	25.0	29.0	37.4	54.0	70.7
Net change in working capital	(40.9)	(44.5)	(36.0)	(27.7)	(20.8)
Others	(42.1)	(42.6)	(62.1)	(73.6)	(78.6)
Cash flow from operations	184.8	200.3	228.2	295.2	337.0
Capital expenditure	(21.7)	(35.4)	(200.0)	(300.0)	(200.0)
Net investments & sale of fixed assets	0.2	0.1	0.1	0.1	0.1
Others	(59.5)	(24.8)	(30.0)	(30.0)	(30.0)
Cash flow from investing	(81.0)	(60.1)	(229.9)	(329.9)	(229.9)
Debt raised/(repaid)	(2.5)	(14.6)	90.0	114.0	119.0
Equity raised/(repaid)	0.0	0.0	0.0	0.0	0.0
Dividends paid	(56.9)	(87.4)	(99.8)	(108.6)	(128.8)
Others	0.3	6.9	0.0	0.0	0.0
Cash flow from financing	(59.1)	(95.0)	(9.8)	5.4	(9.8)
Net cash flow	44.7	45.2	(11.6)	(29.3)	97.4
Net cash/(debt) b/f	47.2	59.7	(101.5)	(143.3)	(21.6)
Net cash/(debt) c/f	78.0	138.6	38.1	(104.2)	(124.8)

Key Ratios (YE 31 Mar)	2011	2012	2013F	2014F	2015F
Revenue growth (%)	28.5	26.7	10.1	20.7	8.7
EBITDA growth (%)	34.3	7.5	14.0	22.6	11.3
Pretax margins (%)	33.0	27.8	28.2	27.7	27.2
Net profit margins (%)	25.9	21.6	22.1	21.7	21.3
Interest cover (x)	98.5	149.3	83.6	40.6	26.2
Effective tax rate (%)	21.6	22.0	21.5	21.5	21.5
Net dividend payout (%)	40.1	45.3	46.1	44.9	44.9
Debtors turnover (days)	43	40	45	44	44
Stock turnover (days)	23	32	36	35	38
Creditors turnover (days)	14	13	13	13	15

Source: Company, AmResearch estimates

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AmResearch Sdn Bhd *(335015-P)*
(A member of the AmInvestment Bank Group)
15th Floor Bangunan AmBank Group
55 Jalan Raja Chulan
50200 Kuala Lumpur
Tel: (03)2070-2444 (research)
Fax: (03)2078-3162

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15th Floor Bangunan AmBank Group
55 Jalan Raja Chulan
50200 Kuala Lumpur
Tel: (03)2070-2444 (research)
Fax: (03)2078-3162

For AmResearch Sdn Bhd

Benny Chew
Managing Director