CLSA
ASIA-PACIFIC MARKETS

Hartalega

RM7.22 - BUY

NEW REC SCHEME See last page

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2 February 2012

Malaysia

Healthcare

Reuters	HTHB.KL
Bloomberg	HART MK

Priced on 31 January 2012
KLSE Comp @ 1,521.3

12M hi/lo RM7.25/5.00

12M price target RM8.60
±% potential +19%

Shares in issue 363.5m
Free float (est.) 44.3%

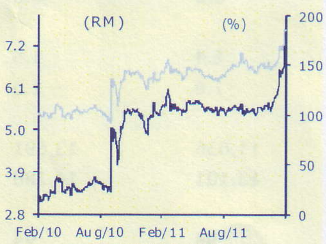
Market cap US$865m

3M average daily volume
RM1.9m (US$.6m)

Major shareholders
Hartalega Industries 50.6%
Budi Tenggara 5.1%

Stock performance (%)

	1M	3M	12M
Absolute	23.6	32.0	28.9
Relative	24.4	28.0	28.8
Abs (US$)	28.9	35.4	29.8



Source: Bloomberg

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Still got legs

Upgrade earnings

Our top pick among the glove makers in Malaysia has been a star performer in the current rally rising 24% in January. Volumes will accelerate sharply in FY3/13 driven by capacity expansion which should drive earnings growth. We are thus revising up our revenue and bottom line estimates by 18% to factor in renewed company focus on driving volumes. Hartalega's has the highest margins and consequently EVA®/IC ratio in the industry but still trades at significant discount to its larger rival Top Glove which we think is unjustified. Maintain BUY with a new target price of RM8.6 implying 23% TSR.

Strong performance but still got legs

Market finally seems to be rewarding Hartalega's superior margins and return ratios as the stock has rallied over 24% in January after being almost flat for 2011. With softening of nitrile prices we expect the structural shift towards nitrile will continue which along with expectations of weaker MYR and attractive valuations should provide support to the stock over 2012.

Volume expansion to drive earnings growth

Hartalega has accelerated its volume expansion plans and is now likely to add another 4bn capacity by May which should take the total capacity to 13.6bn With switching likely to continue in 2012 we expect nitrile segment to grow much faster than overall industry growth of 8-10% which should support the increase in capacity.

Massive EVA® growth, all return ratios above industry average

Although increase in competition will lead to some margin pressures, Hartalega's return ratios remain well above its cost of capital implying volume growth will lead to massive EVA® creation. We are forecasting Hartalega's EVA® to rise 29% in FY13. Note, Top Glove went through a massive re-rating in multiples in 2005-06 as it kept expanding profits and EVA® even though margins declined during the same period.

Valuations still attractive, Maintain BUY

The stock still remains attractively valued at 10.3x FY3/13 earnings which looks very striking considering its FY11-14 earnings cagr of 14% and 36% average ROE over FY12-14. Top Glove the industry leader in comparison trades at 16x although its growth and returns ratios are inferior. Our target price of RM8.6 is derived by applying peer multiple P/E ratio of 12.9x to 2012 earnings. Yield of 4.4% adds extra juice to the investments.

Financials

Year to 31 Mar	10A	11A	12CL	13CL	14CL
Revenue (RMm)	572	735	879	1,178	1,309
Rev forecast change (%)	-	-	*(7.2)*	*18.0*	*12.7*
Net profit (RMm)	143	190	204	255	285
NP forecast change (%)	-	-	*(1.6)*	*18.8*	*18.8*
EPS (sen)	39.3	52.4	56.2	70.2	78.3
CL/consensus (8) (EPS%)	-	-	100	110	105
EPS growth (% YoY)	69.1	33.2	7.3	24.9	11.6
PE (x)	18.4	13.8	12.8	10.3	9.2
Dividend yield (%)	1.8	2.9	3.5	4.4	4.9
ROE (%)	47.0	44.8	37.1	37.7	34.5
Net debt/equity (%)	(9.4)	(15.8)	(22.9)	(31.6)	(38.4)

Source: CLSA Asia-Pacific Markets

Still got legs

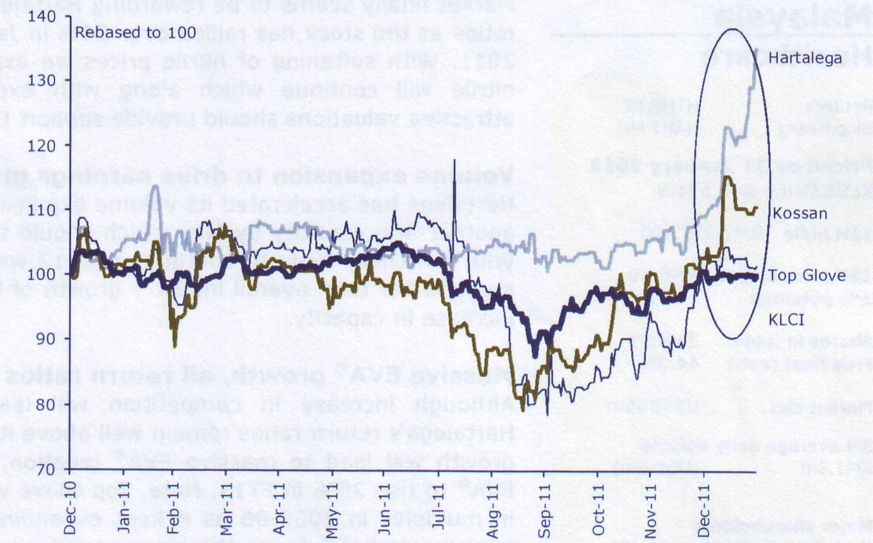
Star performed in Jan 2012

Hartalega has been a star performed in 2012 with the stock gaining 24% YTD. However, we believe that with the sector benefitting from softer raw material prices and currency tailwinds the stock still has significant upside even from current levels as the market is still not fully valuating the fundamental strength of its business which allows the company to generate above average returns. We are raising our target prices to RM8.60 implying 19% upside and 4% yield from current levels. While volume growth will drive earnings in FY3/13 improvement in liquidity should lead to a valuation re-rating more commensurate to its growth and return profile.

Market finally seems to have realised the superior returns

Figure 1

Hartalega stock price performance vs peers and KLCI index



Source: CLSA Asia-Pacific Markets

Key change to our forecast is volume growth

Figure 2

Key assumption changes

	FY12	FY13	FY14
MYR/USD			
Old	3.02	3.01	2.96
New	3.07	3.27	3.31
Latex prices (MYR/Kg)			
Old	8.2	7.6	7.6
New	7.5	6.3	6.3
Nitrile prices (US$/Kg)			
Old	1.7	1.4	1.5
New	1.7	1.6	1.6
Capacity (mn pieces)			
Old	8,970	11,036	13,691
New	8,970	13,101	14,280
Utilization rate (%)			
Old	88	94	94
New	89	85	85

Source: CLSA Asia-Pacific Markets

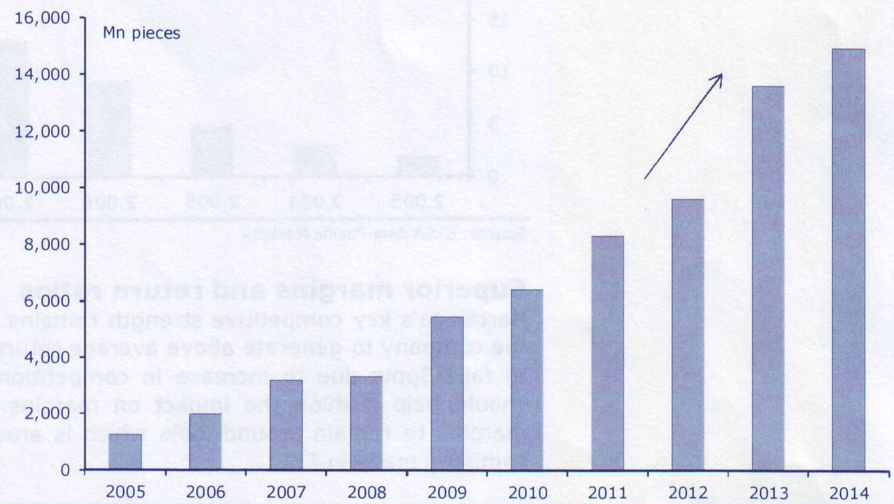
Volume expansion to drive earnings growth

The company has fast tracked its expansion plans with two new lines with 0.5bn capacity to be open in February while plant 6 with 3.5bn is expected to be ready by 1QFY3/12 taking total capacity to 13.7bn. Sharp expansion in volume is supported by buoyant demand environment driven by the continuing shift towards nitrile in developed markets as well as resilience of the overall glove demand which is inelastic in nature.

FY13 will see capacity expanding by 4bn pieces or almost 40%

Figure 3

Hartalega capacity expansion



Source: CLSA Asia-Pacific Markets

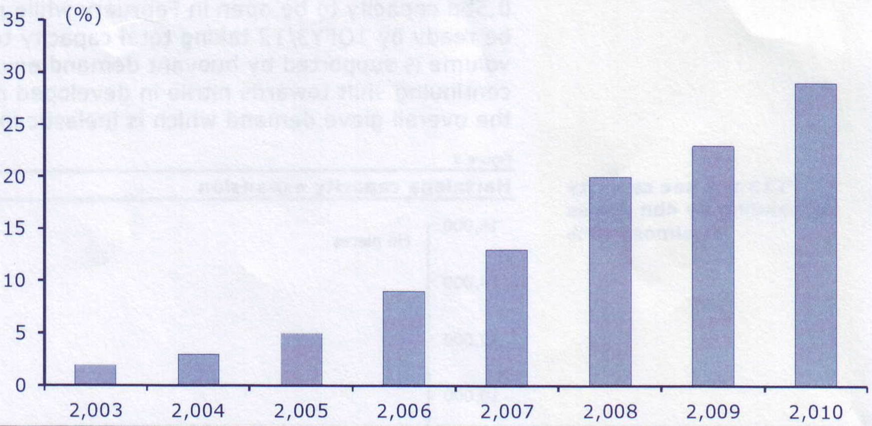
Nitrile shift will continue

Overall glove market is currently dominated by the natural latex segment which still account for roughly 70% of all gloves sold. However, the growth in imports of Nitrile gloves has been growing at a much faster clip and (30% cagr for US over 2005-2010) and long term most industry players expects the split between Nitrile and Natural latex to be roughly 50:50. Nitrile is already the dominant product in the US market and recent trends indicate a similar trend in Europe. With nitrile gloves being more competitive than natural latex gloves as current prices we expect the nitrile segment to keep growing much faster than the overall glove industry.

Hartalega is the world's largest nitrile glove manufacturer with strong established relationships all big distributors and thus will be a key beneficiary of this trend. With increase in capacity we believe that Hartalega can further increase its share of the nitrile market which currently stands at 30% for US and 17% globally.

Figure 4

Hartalega's market share in the US Nitrile market



Source: CLSA Asia-Pacific Markets

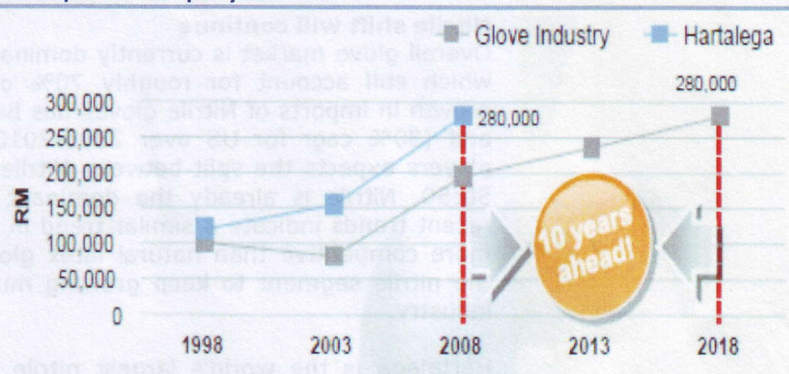
Superior margins and return ratios

Hartalega's key competitive strength remains its efficiency levels which allow the company to generate above average returns. Although we expect margins to fall2-3ppts due to increase in competition softening raw material prices should help cushion the impact on margins. We are forecasting net profit margins to remain around 22% which is around 3ppts lower than what the company made in FY11.

Hartalega is the most efficient glove producers on most metrics

Figure 5

Revenue per worker per year



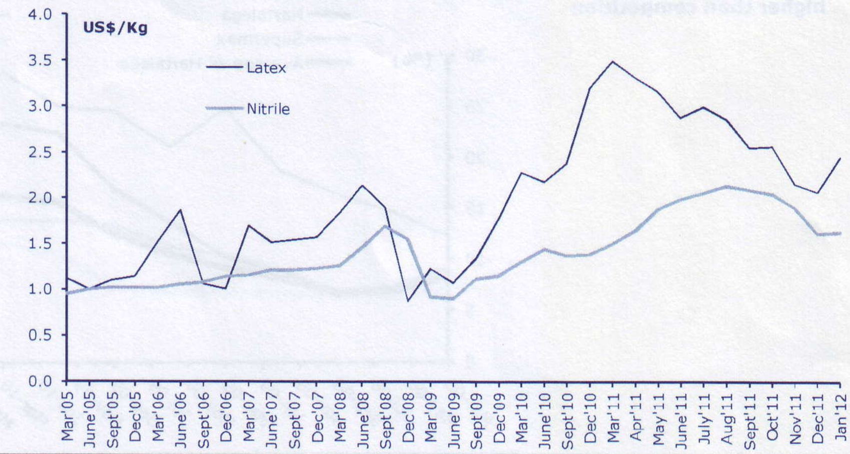
Source: CLSA Asia-Pacific Markets, Margma

Have

Nitrile still remains cheaper than latex

Figure 6

Nitrile prices have also seen a sharp correction

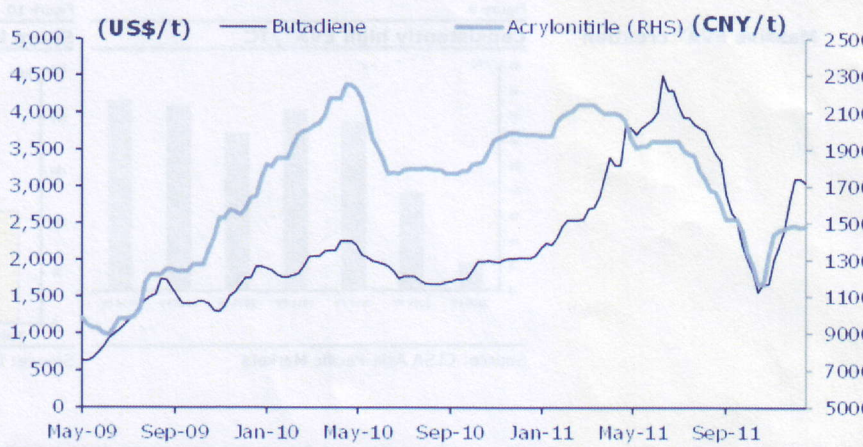


Source: CLSA Asia-Pacific Markets, Top Glove

Raw material prices are down sharply from peak

Figure 7

Softening raw material prices



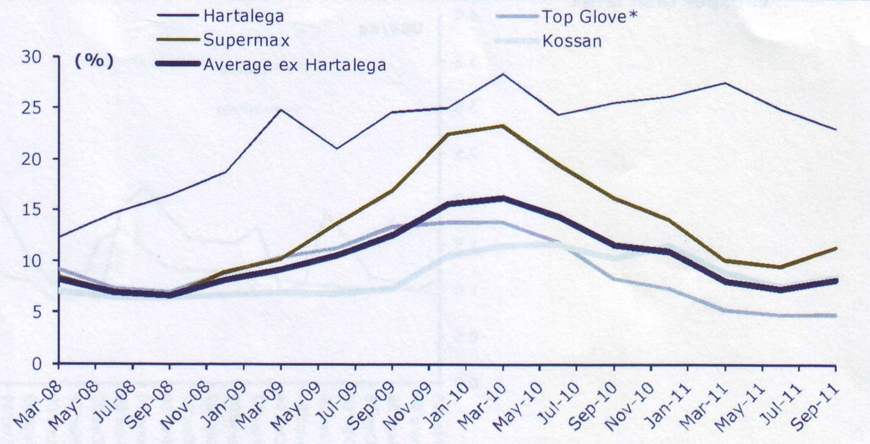
Source: CLSA Asia-Pacific Markets, Bloomberg

Margins might have peaked but not EVA® or profits

One of the key investor concerns has been the expected decline in margins over next few years. However we argue that since Hartalega's margins and consequently its ROIC remains significantly above its cost of capital. Thus if the company can grow much faster by sacrificing some margin it will still generate significantly higher EVA® as higher growth will more than compensate for the decline in return on capital.

Margins are almost 8ppts higher than competition

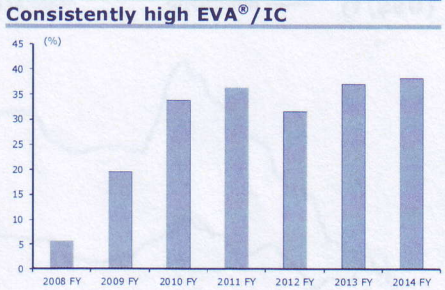
Figure 8
Net profit margin comparison across major glove players



Source: CLSA Asia-Pacific Markets

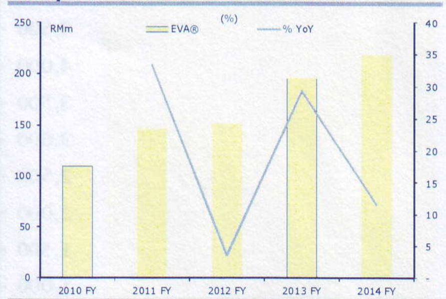
Massive EVA® creation

Figure 9
Consistently high EVA®/IC



Source: CLSA Asia-Pacific Markets

Figure 10
Sharp increase in EVA® creation



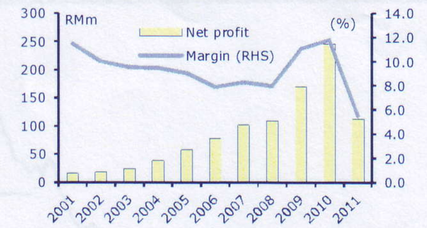
Source: CLSA Asia-Pacific Markets

As a comparison Top Glove during its expansion phase in 2005-06 got re-rated massively as it grew earnings and EVA as fast clip although margins declined during the same period. Thus although we saw net margins for Top Glove decline 2ppts during 2004-06 profit growth was still a very healthy 40%. Market rewarded the company with a massive expansion in multiple from 9x to 18x. Hartalega could see a similar re-rating as it embarks on a multi-year growth phase even at slightly lower margins.

Market rewarded earnings and EVA® growth at Top Glove with significant multiple expansion even though margins contracted during the same period

Figure 11

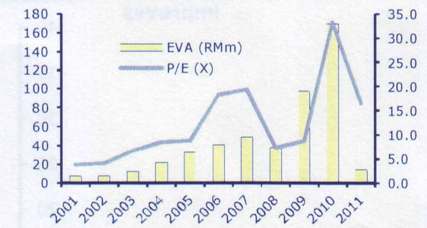
Top Glove - Net profit and margins



Source: CLSA Asia-Pacific Markets

Figure 12

Top Glove – P/E and EVA



Source: CLSA Asia-Pacific Markets XXXXXXXXX

Attractive valuations + juicy yields

We derive our target price of RM8.6 by applying the peer average multiple to 2012 earnings. The company is currently trading at 10.3x FY3/13 earnings however we believe that strong earnings growth, superior competitive positioning and high ROE's should warrant a rerating at least in line with peer average. In addition the company also offers dividend yield of 4% thus implying a TSR of 23%.

As the liquidity and market cap of the stock improves we expect the valuation differential between Top Glove and Hartalega to narrow as the latter scores better on almost all fundamental measures vs Top Glove.

Hartalega still at discount to peer average

Figure 13

Peer comp table

Co.	Code	PE (X) 12CL	PB (X) 12CL	ROE (%) 12CL	Yield (X) 12CL
Hartalega	HART MK	10.3	3.7	39.5	4.2
Kossan	KRI MK	9.0	1.8	20.5	2.9
Ansell	ANS AU	14.8	2.7	20.5	3.0
Supermax	SUCB MK	10.0	1.5	16.2	2.4
Top Glove	TOPG MK	17.0	2.6	14.2	2.1
Sector avg		**12.9**	**2.4**	**22.2**	**3.0**

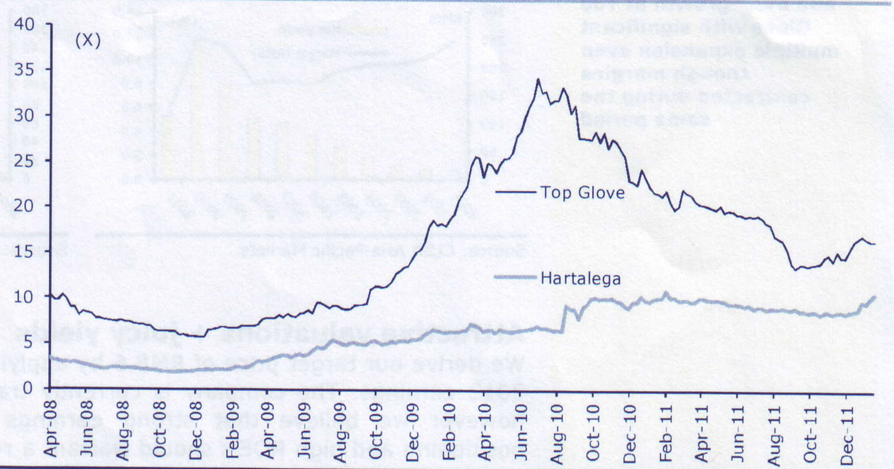
Source: CLSA Asia-Pacific Markets, Bloomberg

Source: CLSA Asia-Pacific Markets

Valuation differential should narrow as liquidity improves

Figure 14

Valuation differential between Hartalega and Top Glove



Source: CLSA Asia-Pacific Markets

Hartalega superior on all fundamental and valuation measures

Figure 15

Hartalega vs Top Glove

	Top Glove	Hartalega
Product mix	Primarily low end powdered latex 55%	Almost 100% powder free nitrile
Technological capabilities	Evolving, production lines are a bit dates.	Best in class, ability to produce gloves meeting FDA norms at 3.5g vs 4-4.5g for peers. Most efficient production lines on almost all metrics among Malaysian glove makers
Pricing power	Low as customers in the powdered latex segment tend to more prices sensitive and high volatility in latex prices makes it difficult to adjust ASP's with raw material prices.	Moderate as supply higher end products and less volatility in nitrile prices means easier to adjust prices
Long term growth prospects	8-10% revenue growth	8-10% revenue growth
2011-13 avg ROE	13.7	34.8
2011 - 13 avg ROIC	15.6	46.5
FY10-13 EPS cagr	negative	14%
P/E (x) 12CL	16.6	10.9
Dividend Yield (12CL)	2.4	4.1
FCF Yield (12CL)	7.3	7.3
Market Cap (US$m)	1030	865
3m ADV (US$m)	1.5	0.6

Source: CLSA Asia-Pacific Markets

evalu@tor The Asia-Pacific Market Database

Summary financials

Year to 31 March	2010A	2011A	2012CL	2013CL	2014CL
Summary P&L forecast (RMm)					
Revenue	**572**	**735**	**879**	**1,178**	**1,309**
Op Ebitda	200	271	291	357	397
Op Ebit	180	242	262	324	360
Interest income	1	3	3	6	8
Interest expense	(3)	(2)	(2)	(2)	(2)
Other items	-	-	-	-	-
Profit before tax	**178**	**243**	**262**	**327**	**365**
Taxation	(35)	(53)	(58)	(72)	(80)
Minorities/Pref divs	0	0	0	0	0
Net profit	**143**	**190**	**204**	**255**	**285**
Summary cashflow forecast (RMm)					
Operating profit	**180**	**242**	**262**	**324**	**360**
Operating adjustments	-	-	-	-	-
Depreciation/amortisation	20	29	29	33	37
Working capital changes	(15)	(41)	(1)	4	(3)
Net interest/taxes/other	(22)	(47)	(60)	(75)	(83)
Net operating cashflow	**163**	**182**	**230**	**287**	**311**
Capital expenditure	(67)	(81)	(80)	(80)	(80)
Free cashflow	**96**	**101**	**150**	**207**	**231**
Acq/inv/disposals	0	0	-	-	-
Int, invt & associate div	1	2	3	6	8
Net investing cashflow	**(65)**	**(79)**	**(77)**	**(74)**	**(72)**
Increase in loans	(15)	(2)	0	0	0
Dividends	(45)	(57)	(92)	(115)	(128)
Net equity raised/other	0	0	0	0	0
Net financing cashflow	**(60)**	**(59)**	**(92)**	**(115)**	**(128)**
Incr/(decr) in net cash	**38**	**45**	**61**	**98**	**111**
Exch rate movements	(1)	(2)	0	0	0
Opening cash	**38**	**75**	**117**	**178**	**276**
Closing cash	**75**	**117**	**178**	**276**	**387**
Summary balance sheet forecast (RMm)					
Cash & equivalents	75	117	178	276	387
Debtors	83	101	121	162	180
Inventories	28	65	61	44	40
Other current assets	0	3	3	3	3
Fixed assets	293	349	400	447	489
Intangible assets	0	0	0	0	0
Other term assets	0	0	0	0	0
Total assets	**479**	**635**	**763**	**932**	**1,100**
Short-term debt	14	15	15	15	15
Creditors	44	57	73	101	112
Other current liabs	11	7	7	7	7
Long-term debt/CBs	28	24	24	24	24
Provisions/other LT liabs	28	37	37	37	37
Minorities/other equity	0	0	1	1	1
Shareholder funds	354	494	607	747	904
Total liabs & equity	**479**	**635**	**763**	**932**	**1,100**
Ratio analysis					
Revenue growth (% YoY)	29.0	28.5	19.7	34.0	11.2
Ebitda growth (% YoY)	86.9	35.5	7.4	22.9	11.0
Ebitda margin (%)	34.9	36.8	33.0	30.3	30.3
Net profit margin (%)	25.0	25.9	23.2	21.7	21.7
Dividend payout (%)	33.9	40.1	45.0	45.0	45.0
Effective tax rate (%)	19.5	21.6	22.0	22.0	22.0
Ebitda/net int exp (x)	95.0	-	-	-	-
Net debt/equity (%)	(9.4)	(15.8)	(22.9)	(31.6)	(38.4)
ROE (%)	47.0	44.8	37.1	37.7	34.5
ROIC (%)	44.7	47.3	42.6	48.0	49.1
EVA®/IC (%)	33.8	36.4	31.7	37.2	38.3

Source: CLSA Asia-Pacific Markets

Companies mentioned

Recommendation history - Hartalega Holdings Bhd HART MK

Date	Rec level*	Closing price	Target
14 September 2011	BUY	5.55	7.30
19 March 2011	BUY	5.55	7.40

Source: CLSA Asia-Pacific Markets

*** Prior to 1 Jan 2012, our rating structure was: BUY = Expected to outperform the local market by >10%; O-PF = Expected to outperform the local market by 0-10%; U-PF = Expected to underperform the local market by 0-10%; SELL = Expected to underperform the local market by >10%.**

Key to CLSA investment rankings: BUY: Total return expected to exceed market return AND provide 20% or greater absolute return; **O-PF**: Total return expected to be greater than market return but less than 20% absolute return; **U-PF**: Total return expected to be less than market return but expected to provide a positive absolute return; **SELL**: Total return expected to be less than market return AND to provide a negative absolute return. For relative performance, we benchmark the 12-month total return (including dividends) for the stock against the 12-month forecast return (including dividends) for the local market where the stock is traded.

CLSA changed the methodology by which it derives its investment rankings on 1 January 2012. The stocks covered in this report are subject to the revised methodology. We have made no changes to the methodologies through which analysts derive price targets - our views on intrinsic values and appropriate price targets are unchanged by this revised methodology. For further details of our new investment ranking methodology, please refer to our website.