CIMB Research Report

QUICK TAKES

31 May 2011

MALAYSIA

Rubber Gloves

NEUTRAL Downgraded

Getting its wrists slapped by higher energy costs

Terence Wong CFA +60(3) 20849689 - terence.wong@cimb.com

Higher electricity and gas tariffs

Downgrade sector to NEUTRAL. The government will raise electricity tariffs and gas prices on 1 June 2011. The higher electricity tariff was not entirely unexpected but the gas hike is a negative surprise for glovemakers. This lowers FY12 EPS by 3-9% and target prices by 13-19%. We now downgrade Top Glove from Neutral to Underperform and Adventa from Outperform to Underperform. Our valuation basis for Top Glove is now a 10% discount to our target market P/E of 14.5x or 13.05x. Correspondingly, our target prices for the other glovemakers are adjusted downwards. As a result, the sector is downgraded from Overweight to NEUTRAL as we were over optimistic about the sector's cost-pass-through mechanisms and demand. We see undemanding valuations balanced by poor earnings visibility due to high input costs, a weakening US$ and now higher energy costs. Kossan remains our top pick.

The news

Tenaga Nasional Berhad (TNB) is raising electricity tariffs to cover the additional cost resulting from Petronas's 28% increase in the natural gas price charged to the power sector from RM10.70/mmBTU to RM13.70/mmBTU effective 1 June 2011.

Overall, TNB is increasing its power rates by 7.12%. Industrial consumers will experience an average increase of 8.3% (ranging from 6.2% to 10%). Special industrial tariff consumers will see tariffs rise c.10%. The increase in tariffs is in line with the government's efforts to reduce gradually the subsidies for the industrial sector.

Bloomberg also reported that the Minister of Energy, Green Technology and Water Datuk Seri Peter Chin Fah Kui said that gas prices for industries will be raised by 17% from RM15.35/mmBTU to RM18.00/mmBTU.

Comments

Gas increase a surprise. Although the higher electricity rates are not entirely unexpected as rumours have been circulating for weeks (see our 30 May note), the increase in gas price was a surprise as we did not expect the government to announce higher gas prices so soon. The increase in energy costs is negative for the rubber glove sector as electricity accounts for 2-4% of total costs and natural gas makes up 3-9% of total operating costs (Figure 1).

Lower competitiveness of industrial sector. The higher energy tariffs are in line with the government's aim to reduce gradually the subsidies for the industrial sector. While this is an appropriate move to reduce the government's budget deficit and align the archaic method of subsidising energy costs to a more transparent pricing mechanism, it reduces the competitiveness of Malaysia's industrial sector. Glovemakers who are already battling with higher input costs, a weaker US$ and weak demand now have to squeeze out further operating efficiencies to offset the higher energy costs.

Figure 1: Impact of higher electricity and gas costs on glovemakers' earnings

FY12 EPS impact from higher electricity and gas costs

Company	FYE	Electricity (%total)	Gas costs (%total)	EBIT margin	FY12 EPS (sen) Pre	Post	% chg
Adventa	31-Oct	3.5%	3.5%	8.2%	29.3	26.6	-9.4%
Hartalega	31-Mar	3.5%	7.2%	33.4%	63.1	61.1	-3.2%
Kossan	31-Dec	4.0%	3.5%	13.9%	45.3	42.4	-6.2%
Latexx	31-Dec	3.0%	9.0%	19.4%	26.9	25.2	-6.3%
Supermax	31-Dec	3.0%	6.0%	12.6%	50.3	45.7	-9.2%
Top Glove	31-Aug	2.0%	3.6%	9.7%	33.7	31.8	-5.7%
Average		**3.2%**	**5.5%**	**16.2%**			**-6.7%**
Highest		**4.0%**	**9.0%**	**33.4%**			**-3.2%**
Lowest		**2.0%**	**3.5%**	**8.2%**			**-9.4%**

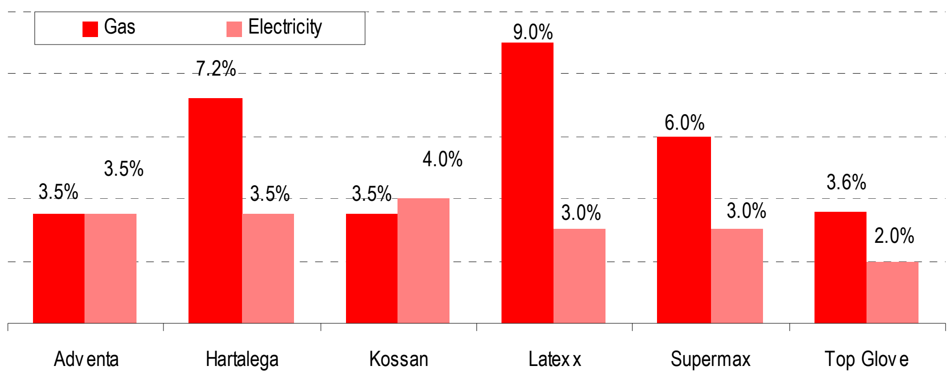
Impact on target prices and recommendations

Company	Target price review Pre	Post	% chg	Recommendation Recomm	Call	Fwd P/E
Adventa	2.98	2.43	-18.5%	U	Downgrade	9.14x
Hartalega	8.23	7.18	-12.8%	O	Maintain	11.75x
Kossan	4.59	3.87	-15.7%	O	Maintain	9.14x
Latexx	2.73	2.28	-16.5%	N	Maintain	9.14x
Supermax	5.84	4.75	-18.7%	B	Maintain	10.44x
Top Glove	5.57	4.76	-14.5%	U	Downgrade	13.05x
Sector			**-16.1%**	N	Downgrade	
Highest			**-12.8%**			
Lowest			**-18.7%**			

Source: Company, CIMB Research

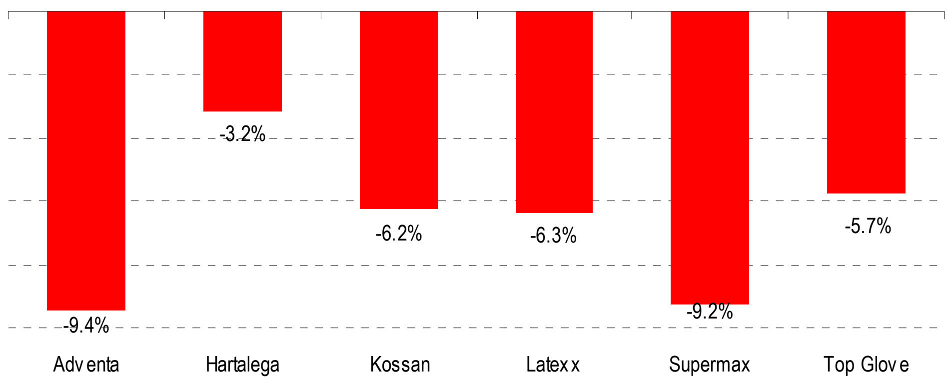
FY12 EPS takes a hit. We now factor in a 10% rise in electricity costs and a 17% rise in gas price effective 1 June 2011. FY12 EPS for the sector falls by an average of 6.7% (a range of 3.2-9.4%). The biggest losers in the sector are Supermax (9.2% EPS downgrade) and Adventa (9.4%). For Adventa, the high FY12 EPS impact is due to the company's lower EBIT margins. For Supermax, the large EPS impact reflects a combination of below-average EBIT margins and its higher dependence on natural gas (6% versus the sector's 5.5%). Least affected is Hartalega with an EPS decline of only 3.2%. Although natural gas makes up 7.2% of Hartalega's total cost compared to 5.5% for the sector, the company's superior operating margins of 33.4% enables it to withstand the higher costs better (Figure 1).

Figure 2: Electricity and gas as a % of total operating costs



Source: Company, CIMB Research

Figure 3: Impact on FY12 EPS from a 10% rise in electricity costs and 17% rise in gas costs



Source: Company, CIMB Research

Valuation and recommendation

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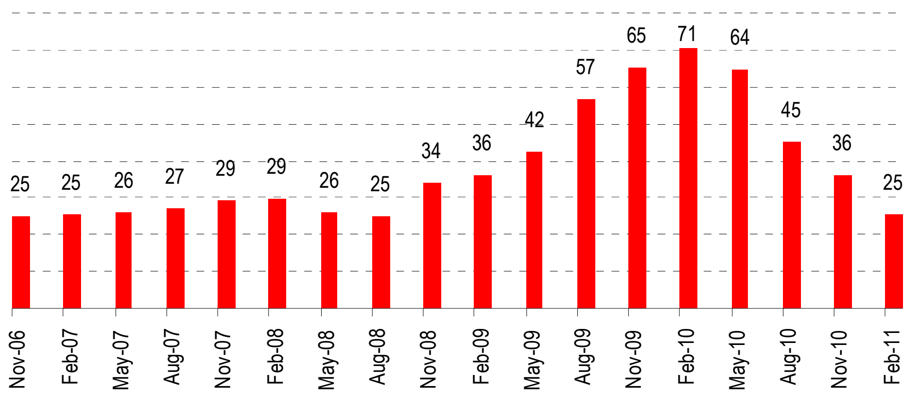
Top Glove's traditional business model of mass production of low-grade gloves has broken down of late. Higher natural rubber latex price has taken its toll on the company. Although Top Glove is looking to raise its nitrile contribution, it is facing operational challenges in doing so. Adding to the cost pressure is the normalisation of demand. Earlier this month, the company cut its planned capacity expansion for FY11 by 36% from 7.8bn pieces of gloves to 4.8bn pieces of gloves. Due to higher working capital requirements resulting from the high natural rubber prices, cash balances halved qoq to RM13m. To conserve cash, Top Glove cut its FY11 DPS guidance from 16 sen to a 50% payout, which, at that time, lowered our FY11 DPS estimate by 41% to 9.4 sen. Valuations are also high at 22.7x FY11 P/E and 14.2x FY12 P/E, which we believe does not justify the company's weakening competitive position and meagre 3-year EPS CAGR of only 4.8%.

Figure 4: Top Glove's deteriorating competitiveness



Source: Company, Bloomberg, CIMB Research

Figure 5: Sector comparisons

	Bloomberg ticker	Recom.	Price (Local)	Target price (Local)	Mkt cap (US$ m)	Core P/E (x) CY2011	Core P/E (x) CY2012	3-yr EPS CAGR (%)	P/BV (x) CY2011	ROE (%) CY2011	Div yield (%) CY2011
Adventa	ADV MK	U	2.12	2.43	107	11.8	8.0	2.7	1.1	10.7	3.4
Hartalega	HART MK	O	5.66	7.18	682	10.5	9.3	12.8	3.7	38.2	5.0
Kossan	KRI MK	O	3.00	3.87	318	8.5	7.1	10.5	1.7	22.1	3.3
Latexx	LTX MK	N	2.18	2.28	160	7.3	7.0	3.6	1.6	25.0	3.7
Supermax	SUCB MK	O	3.65	4.75	411	8.1	8.0	1.3	1.4	19.2	3.0
Top Glove	TOPG MK	U	5.15	4.76	1,055	22.5	14.1	4.8	2.6	12.1	2.7
Simple average						**11.8**	**8.0**	**2.7**	**1.1**	**10.7**	**3.4**

O = Outperform, N = Neutral, U = Underperform, TB = Trading Buy and TS = Trading Sell
Source: Company, CIMB Research

COMPANY BRIEFS…

CIMB Research Report

Adventa Bhd

Getting its wrists slapped by higher energy costs

QUICK TAKES

31 May 2011

Syariah-compliant stock

UNDERPERFORM Downgraded

RM2.12 Target: RM2.43

Mkt.Cap: RM324m/US$107m

Rubber Gloves

MALAYSIA

ADV MK / ADVE.KL

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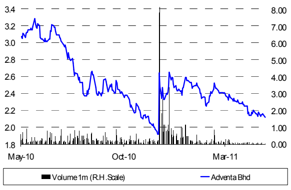
Price chart



Source: Bloomberg

Financial summary

FYE Oct	2009	2010	2011F	2012F	2013F
Revenue (RM m)	282.7	336.2	453.0	552.9	732.9
EBITDA (RM m)	45.0	49.0	45.8	65.0	64.3
EBITDA margins (%)	15.9%	14.6%	10.1%	11.8%	8.8%
Pretax profit (RM m)	18.6	30.5	27.0	44.5	42.2
Net profit (RM m)	17.2	35.8	24.8	41.0	38.8
EPS (sen)	11.2	23.4	16.2	26.8	25.4
EPS growth (%)	24.3%	108.9%	(30.7%)	65.1%	(5.2%)
P/E (x)	18.9	9.0	13.1	7.9	8.3
Core EPS (sen)	18.2	23.4	16.2	26.8	25.4
Core EPS growth (%)	101.4%	28.9%	(30.7%)	65.1%	(5.2%)
Core P/E (x)	11.7	9.0	13.1	7.9	8.3
Gross DPS (sen)	7.4	9.3	6.5	10.7	10.2
Dividend yield (%)	3.5%	4.4%	3.1%	5.1%	4.8%
P/BV (x)	1.8	1.5	1.2	1.0	0.8
ROE (%)	9.3%	16.1%	9.0%	12.1%	9.7%
Net gearing (%)	41.6%	40.8%	48.6%	45.6%	33.6%
P/FCFE (x)	139.7	(191.4)	(11.6)	3,088.2	7.8
EV/EBITDA (x)	8.9	8.4	10.0	7.4	7.2
% change in EPS estimates			(5.3%)	(8.9%)	(12.3%)
CIMB/Consensus (x)			0.93	1.06	1.00

Source: Company, CIMB Research, Bloomberg

CIMB

CIMB Research Report

Hartalega Holdings

Getting its wrists slapped by higher energy costs

QUICK TAKES

31 May 2011

Syariah-compliant stock

OUTPERFORM	Maintained
RM5.66	Target: RM7.18
	Mkt.Cap: RM2,058m/US$682m
	Rubber Gloves

MALAYSIA

HART MK / HTHB.KL **Terence Wong CFA** +60(3) 20849689 – terence.wong@cimb.com

Higher electricity and gas tariffs

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Lower competitiveness of industrial sector. The higher energy tariffs are in line with the government's aim to reduce gradually the subsidies for the industrial sector. While this is an appropriate move to reduce the government's budget deficit and align the archaic method of subsidising energy costs to a more transparent pricing mechanism, it reduces the competitiveness of Malaysia's industrial sector. Glovemakers who are already battling with higher input costs, a weaker US$ and weak demand now have to squeeze out further operating efficiencies to offset the higher energy costs.

Valuation and recommendation

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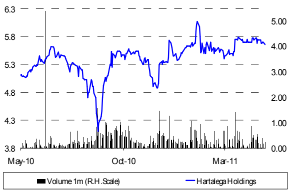
Financial summary

FYE Mar	2010	2011	2012F	2013F	2014F
Revenue (RM m)	571.9	734.9	821.7	905.5	1,067.2
EBITDA (RM m)	202.7	266.1	271.6	316.6	372.7
EBITDA margins (%)	35.4%	36.2%	33.1%	35.0%	34.9%
Pretax profit (RM m)	177.8	243.4	245.9	288.5	342.2
Net profit (RM m)	142.9	190.3	196.6	230.6	273.5
EPS (sen)	39.3	52.4	54.1	63.5	75.2
EPS growth (%)	69.1%	33.2%	3.3%	17.3%	18.6%
P/E (x)	14.4	10.8	10.5	8.9	7.5
Core EPS (sen)	40.0	52.4	54.1	63.5	75.2
Core EPS growth (%)	82.2%	31.0%	3.3%	17.3%	18.6%
Core P/E (x)	14.2	10.8	10.5	8.9	7.5
Gross DPS (sen)	13.3	27.0	28.8	33.8	40.1
Dividend yield (%)	2.4%	4.8%	5.1%	6.0%	7.1%
P/BV (x)	5.8	4.2	3.5	2.9	2.3
ROE (%)	47.0%	44.9%	36.5%	35.4%	34.1%
Net cash per share (RM)	0.09	0.21	0.46	0.61	0.97
P/FCFE (x)	24.9	20.8	13.9	16.9	9.6
EV/EBITDA (x)	10.0	7.4	7.0	5.8	4.6
% change in EPS estimates			(2.9%)	(3.2%)	(3.2%)
CIMB/Consensus (x)			0.93	0.96	0.82

Source: Company, CIMB Research, Bloomberg

Price chart



Source: Bloomberg

CIMB Research Report

Kossan Rubber Industries Bhd

Getting its wrists slapped by higher energy costs

QUICK TAKES

31 May 2011

Syariah-compliant stock

OUTPERFORM	Maintained
RM3.00	Target: RM3.87
	Mkt.Cap: RM959m/US$318m
	Rubber Gloves

MALAYSIA

KRI MK / KRIB.KL

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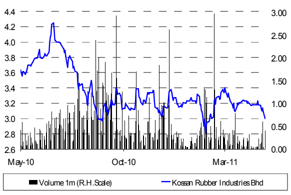
Revenue (RM m)	842.1	1,047.9	1,322.1	1,474.1	1,699.6
EBITDA (RM m)	128.5	190.0	201.2	242.4	285.2
EBITDA margins (%)	15.3%	18.1%	15.2%	16.4%	16.8%
Pretax profit (RM m)	85.8	148.1	147.5	179.9	211.6
Net profit (RM m)	66.7	118.2	112.6	135.6	159.4
EPS (sen)	20.9	37.0	35.2	42.4	49.9
EPS growth (%)	13.7%	77.2%	(4.7%)	20.4%	17.5%
P/E (x)	14.4	8.1	8.5	7.1	6.0
Gross DPS (sen)	4.5	8.0	10.0	12.0	14.0
Dividend yield (%)	1.5%	2.7%	3.3%	4.0%	4.7%
P/BV (x)	2.7	2.1	1.7	1.4	1.2
ROE (%)	20.3%	28.9%	22.1%	22.1%	21.6%
Net gearing (%)	50.8%	26.8%	10.6%	N/A	N/A
Net cash per share (RM)	N/A	N/A	N/A	0.03	0.32
P/FCFE (x)	(226.5)	14.9	12.0	10.6	3.7
EV/EBITDA (x)	8.9	5.7	5.1	3.9	3.0
% change in EPS estimates			(4.1%)	(6.3%)	(6.1%)
CIMB/Consensus (x)			0.90	0.99	1.02

Source: Company, CIMB Research, Bloomberg

Price chart



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CIMB

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Latexx Partners

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Syariah-compliant stock

NEUTRAL	Maintained
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	Rubber Gloves

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LTX MK / LATX.KL

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Electricity hike expected but gas increase a surprise. Although the higher electricity rates are not a surprise as rumours have been circulating for weeks (see our 30 May note), the increase in gas price was a surprise as we did not expect the government to announce higher gas prices so soon. The increase in energy costs is negative for the rubber glove sector as electricity accounts for 2-4% of total costs and natural gas makes up 3-9% of total operating costs.

Lower competitiveness of industrial sector. The higher energy tariffs are in line with the government's aim to reduce gradually the subsidies for the industrial sector. While this is an appropriate move to reduce the government's budget deficit and align the archaic method of subsidising energy costs to a more transparent pricing mechanism, it reduces the competitiveness of Malaysia's industrial sector. Glovemakers who are already battling with higher input costs, a weaker US$ and weak demand now have to squeeze out further operating efficiencies to offset the higher energy costs.

Valuation and recommendation

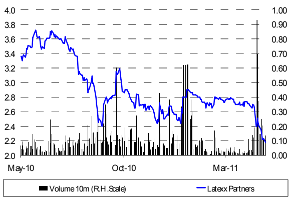
Maintain NEUTRAL. On the heels of the energy rate hikes announced yesterday, we raise our electricity cost assumptions by 10% and gas prices by 17% effective 1 June 2011. FY11-13 EPS for Latexx falls by 5-7%, resulting in a fall in our target from RM 2.73 to RM2.28 based on a 9.14x forward P/E or a 30% discount to Top Glove's forward P/E of 13.05x. As a result, we cut our rating from Neutral to UNDERPERFORM. The rise in latex price has taken its toll on the company and the higher energy costs cuts earnings visibility. De-rating catalysts include the energy cost increase, high switching costs, poor results and high valuations. We prefer Kossan.

Financial summary

FYE Dec	2009	2010	2011F	2012F	2013F
Revenue (RM m)	328.5	497.3	503.8	482.5	501.7
EBITDA (RM m)	66.7	101.5	104.0	111.3	126.4
EBITDA margins (%)	20.3%	20.4%	20.6%	23.1%	25.2%
Pretax profit (RM m)	51.8	84.8	83.2	86.7	97.8
Net profit (RM m)	51.3	70.4	66.6	69.4	78.2
EPS (sen)	23.1	31.7	30.0	31.2	35.2
EPS growth (%)	237.8%	37.1%	(5.4%)	4.2%	12.8%
P/E (x)	9.4	6.9	7.3	7.0	6.2
FD core EPS (sen)	18.5	25.3	23.9	24.9	28.1
FD core P/E (x)	11.8	8.6	9.1	8.7	7.7
Gross DPS (sen)	2.0	7.5	8.0	8.3	9.4
Dividend yield (%)	0.9%	3.4%	3.7%	3.8%	4.3%
P/BV (x)	2.9	2.0	1.6	1.4	1.2
ROE (%)	35.3%	34.6%	25.0%	21.4%	20.3%
Net gearing (%)	43.0%	20.0%	10.1%	1.1%	N/A
Net cash per share (RM)	N/A	N/A	N/A	N/A	0.13
P/FCFE (x)	35.2	13.1	11.2	8.7	6.7
EV/EBITDA (x)	8.3	5.2	4.9	4.4	3.6
% change in EPS estimates			(4.7%)	(7.1%)	(6.5%)
CIMB/Consensus (x)			0.95	0.91	0.93

Source: Company, CIMB Research, Bloomberg

Price chart



Source: Bloomberg

CIMB Research Report

Supermax Corp Bhd

Getting its wrists slapped by higher energy costs

OUTPERFORM	Maintained
RM3.65	Target: RM4.75
	Mkt.Cap: RM1,241m/US$411m
	Rubber Gloves

SUCB MK / SUPM.KL | **Terence Wong CFA** +60(3) 20849689 – terence.wong@cimb.com

Higher electricity and gas tariffs

Maintain OUTPERFORM. We raise our electricity cost assumptions by 10% and gas prices by 17% effective 1 June 2011. FY11-13 EPS for Supermax falls by 4-10%, resulting in a cut in the target price from RM5.84 to RM4.75 based on a 10.44x forward P/E or a 20% discount to Top Glove's 13.05x target P/E. Despite the cut, we remain positive about the company's longer-term prospects as we expect natural rubber latex prices to fall in 2H11 as rubber trees emerge from the wintering period. We also expect rubber demand growth to slow down as higher interest rates in China and India start to take a toll on auto sales. We retain our OUTPERFORM rating in view of the potential re-rating catalysts of 1) earnings growth for its associate, 2) the restart of the Sungai Buloh plant, and 3) tax savings.

The news

Tenaga Nasional Berhad (TNB) is raising electricity tariffs to cover the additional cost resulting from Petronas's 28% increase in the natural gas price charged to the power sector from RM10.70/mmBTU to RM13.70/mmBTU effective 1 June 2011.

Overall, TNB is increasing its power rates by 7.12%. Industrial consumers will experience an average increase of 8.3% (ranging from 6.2% to 10%). Special industrial tariff consumers will see tariffs rise c.10%. The increase in tariffs is in line with the government's efforts to reduce gradually the subsidies for the industrial sector.

Bloomberg also reported that the Minister of Energy, Green Technology and Water Datuk Seri Peter Chin Fah Kui said that gas prices for industries will be raised by 17% from RM15.35/mmBTU to RM18.00/mmBTU.

Comments

Electricity hike expected but gas increase a surprise. Although the higher electricity rates are not a surprise as rumours have been circulating for weeks (see our 30 May note), the increase in gas price was a surprise as we did not expect the government to announce higher gas prices so soon. The increase in energy costs is negative for the rubber glove sector as electricity accounts for 2-4% of total costs and natural gas makes up 3-9% of total operating costs.

Lower competitiveness of industrial sector. The higher energy tariffs are in line with the government's aim to reduce gradually the subsidies for the industrial sector. While this is an appropriate move to reduce the government's budget deficit and align the archaic method of subsidising energy costs to a more transparent pricing mechanism, it reduces the competitiveness of Malaysia's industrial sector. Glovemakers who are already battling with higher input costs, a weaker US$ and weak demand now have to squeeze out further operating efficiencies to offset the higher energy costs.

Valuation and recommendation

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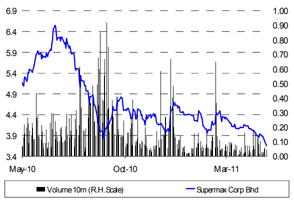
Financial summary

FYE Dec	2009	2010	2011F	2012F	2013F
Revenue (RM m)	803.6	923.3	1,141.6	1,454.5	1,617.6
EBITDA (RM m)	169.0	228.0	188.8	197.2	228.7
EBITDA margins (%)	21.0%	24.7%	16.5%	13.6%	14.1%
Pretax profit (RM m)	151.5	177.0	170.5	171.9	193.8
Net profit (RM m)	126.6	167.8	153.4	154.7	174.4
EPS (sen)	37.2	49.3	45.1	45.5	51.3
EPS growth (%)	169.3%	32.6%	(8.6%)	0.8%	12.7%
P/E (x)	9.8	7.4	8.1	8.0	7.1
Core EPS (sen)	38.5	49.3	45.1	45.5	51.3
Core EPS growth (%)	111.2%	28.0%	(8.6%)	0.8%	12.7%
Core P/E (x)	9.5	7.4	8.1	8.0	7.1
Gross DPS (sen)	8.8	10.0	11.0	12.0	12.0
Dividend yield (%)	2.4%	2.7%	3.0%	3.3%	3.3%
P/BV (x)	2.2	1.7	1.4	1.3	1.1
ROE (%)	26.0%	25.9%	19.2%	16.7%	16.5%
Net gearing (%)	31.5%	16.2%	7.1%	3.0%	N/A
Net cash per share (RM)	N/A	N/A	N/A	N/A	0.19
P/FCFE (x)	11.6	14.3	9.4	11.0	6.9
EV/EBITDA (x)	7.5	5.2	5.9	5.4	4.2
% change in EPS estimates			(4.5%)	(9.6%)	(9.4%)
CIMB/Consensus (x)			1.07	0.96	1.02

Source: Company, CIMB Research, Bloomberg

Price chart



Source: Bloomberg

CIMB

CIMB Research Report

Top Glove Corporation

Getting its wrists slapped by higher energy costs

QUICK TAKES

31 May 2011

Syariah-compliant stock

UNDERPERFORM Downgraded

RM5.15 Target: RM4.76

Mkt.Cap: RM3,185m/US$1,055m

Rubber Gloves

MALAYSIA

TOPG MK / TPGC.KL

Terence Wong CFA +60(3) 20849689 – terence.wong@cimb.com

Higher electricity and gas tariffs

Downgrade to UNDERPERFORM. We raise our electricity cost assumptions by 10% and gas prices by 17% effective 1 June 2011. FY11-13 EPS for Top Glove falls by 4-10%, leading to a cut in our target from RM5.57 to RM4.76, based on a 13.05x forward P/E or a 10% discount to our target P/E of 14.5x. The rise in latex price has taken its toll on the company. Adding to the pressure is the normalising of demand which prompted the company to scale back its planned capacity expansion for FY11 by 36%. Top Glove's valuations are also high, at 22.7x FY11 P/E, which does not justify its weakening competitive position and 3-year EPS CAGR of 4.8%. We downgrade it from Neutral to UNDERPERFORM. De-rating catalysts include the energy cost increase, high switching costs, poor results and high valuations. We prefer Kossan.

The news

Tenaga Nasional Berhad (TNB) is raising electricity tariffs to cover the additional cost resulting from Petronas's 28% increase in the natural gas price charged to the power sector from RM10.70/mmBTU to RM13.70/mmBTU effective 1 June 2011.

Overall, TNB is increasing its power rates by 7.12%. Industrial consumers will experience an average increase of 8.3% (ranging from 6.2% to 10%). Special industrial tariff consumers will see tariffs rise c.10%. The increase in tariffs is in line with the government's efforts to reduce gradually the subsidies for the industrial sector.

Bloomberg also reported that the Minister of Energy, Green Technology and Water Datuk Seri Peter Chin Fah Kui said that gas prices for industries will be raised by 17% from RM15.35/mmBTU to RM18.00/mmBTU.

Comments

Electricity hike expected but gas increase a surprise. Although the higher electricity rates are not a surprise as rumours have been circulating for weeks (see our 30 May note), the increase in gas price was a surprise as we did not expect the government to announce higher gas prices so soon. The increase in energy costs is negative for the rubber glove sector as electricity accounts for 2-4% of total costs and natural gas makes up 3-9% of total operating costs (Figure X).

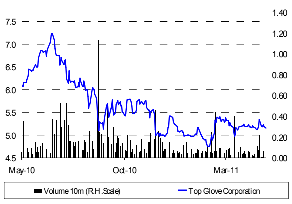
Lower competitiveness of industrial sector. The higher energy tariffs are in line with the government's aim to reduce gradually the subsidies for the industrial sector. While this is an appropriate move to reduce the government's budget deficit and align the archaic method of subsidising energy costs to a more transparent pricing mechanism, it reduces the competitiveness of Malaysia's industrial sector. Glovemakers who are already battling with higher input costs, a weaker US$ and weak demand now have to squeeze out further operating efficiencies to offset the higher energy costs.

Valuation and recommendation

Downgrade to UNDERPERFORM. Downgrade to UNDERPERFORM. We raise our electricity cost assumptions by 10% and gas prices by 17% effective 1 June 2011. FY11-13 EPS for Top Glove falls by 4-10%, leading to a 14% cut in our target to RM4.76, based on a 13.05x forward P/E or a 10% discount to our target P/E of 14.5x. The rise in latex price has taken its toll on the company. Adding to the pressure is the normalising of demand which prompted the company to scale back its planned capacity expansion for FY11 by 36%. Top Glove's valuations are also high, at 22.7x FY11 P/E, which does not justify its weakening competitive position and 3-year EPS CAGR of 4.8%. We downgrade it from Neutral to UNDERPERFORM. De-rating catalysts include the energy cost increase, high switching costs, poor results and high valuations. We prefer Kossan.

Top Glove's traditional business model of mass production of low-grade gloves has broken down of late. Higher natural rubber latex price has taken its toll on the company. Although Top Glove is looking to raise its nitrile contribution, it is facing operational challenges in doing so. Adding to the cost pressure is the normalisation of demand. Earlier this month, the company cut its planned capacity expansion for FY11 by 36% from 7.8bn pieces of gloves to 4.8bn pieces of gloves. Due to higher working capital requirements resulting from the high natural rubber prices, cash balances halved qoq to RM13m. To conserve cash, Top Glove cut its FY11 DPS guidance from 16 sen to a 50% payout, which, at that time, lowered our FY11 DPS estimate by 41% to 9.4 sen. Valuations are also high at 22.7x FY11 P/E and 14.2x FY12 P/E, which we believe does not justify the company's weakening competitive position and meagre 3-year EPS CAGR of only 4.8%.

Price chart



Source: Bloomberg

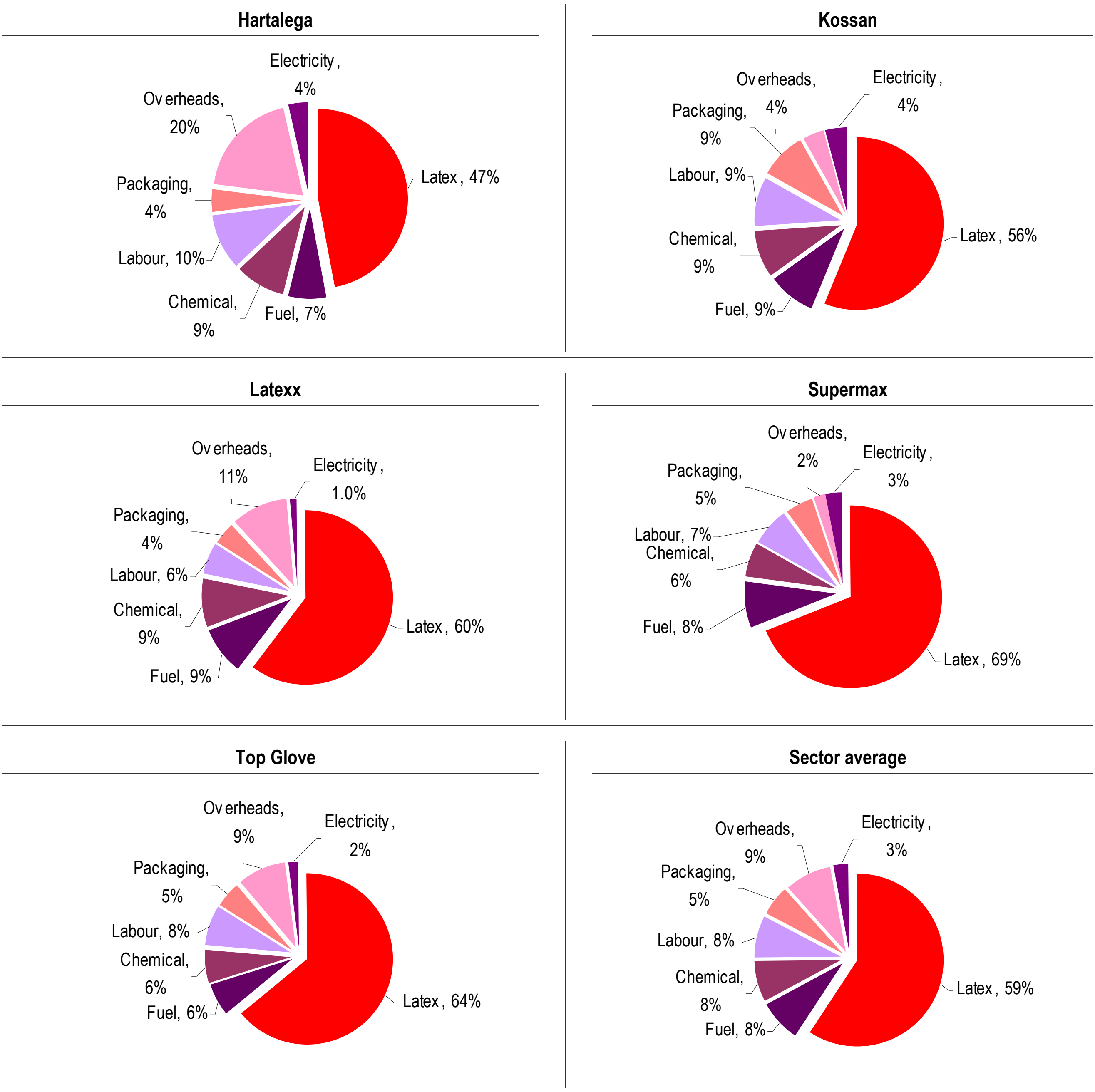
Financial summary

FYE Aug	2009	2010	2011F	2012F	2013F
Revenue (RM m)	1,529.1	2,079.4	1,866.0	2,266.9	2,428.3
EBITDA (RM m)	286.2	362.3	197.7	304.1	413.8
EBITDA margins (%)	18.7%	17.4%	10.6%	13.4%	17.0%
Pretax profit (RM m)	222.0	306.0	144.0	250.6	360.9
Net profit (RM m)	169.1	245.3	113.5	196.7	282.8
EPS (sen)	27.4	39.7	18.4	31.8	45.7
EPS growth (%)	53.7%	45.0%	(53.7%)	73.3%	43.8%
P/E (x)	18.8	13.0	28.1	16.2	11.3
Gross DPS (sen)	10.9	21.3	12.2	17.0	24.4
Dividend yield (%)	2.1%	4.1%	2.4%	3.3%	4.7%
P/BV (x)	3.9	2.9	2.7	2.4	2.1
ROE (%)	22.7%	25.6%	10.1%	15.9%	20.2%
Net cash per share (RM)	0.27	0.48	0.59	0.69	0.97
P/FCFE (x)	57.6	24.4	20.0	28.2	13.3
EV/EBITDA (x)	10.6	8.0	14.4	9.1	6.3
% change in EPS estimates			(4.5%)	(9.6%)	(9.4%)
CIMB/Consensus (x)			0.70	0.91	1.17

Source: Company, CIMB Research, Bloomberg

Appendix 1 – Glovemakers' cost composition

Figure 1: Estimated cost structure for glove manufacturers



Source: Company, CIMB Research

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RECOMMENDATION FRAMEWORK #1 *

STOCK RECOMMENDATIONS	SECTOR RECOMMENDATIONS
OUTPERFORM: The stock's total return is expected to exceed a relevant benchmark's total return by 5% or more over the next 12 months.	**OVERWEIGHT:** The industry, as defined by the analyst's coverage universe, is expected to outperform the relevant primary market index over the next 12 months.
NEUTRAL: The stock's total return is expected to be within +/-5% of a relevant benchmark's total return.	**NEUTRAL:** The industry, as defined by the analyst's coverage universe, is expected to perform in line with the relevant primary market index over the next 12 months.
UNDERPERFORM: The stock's total return is expected to be below a relevant benchmark's total return by 5% or more over the next 12 months.	**UNDERWEIGHT:** The industry, as defined by the analyst's coverage universe, is expected to underperform the relevant primary market index over the next 12 months.
TRADING BUY: The stock's total return is expected to exceed a relevant benchmark's total return by 5% or more over the next 3 months.	**TRADING BUY:** The industry, as defined by the analyst's coverage universe, is expected to outperform the relevant primary market index over the next 3 months.
TRADING SELL: The stock's total return is expected to be below a relevant benchmark's total return by 5% or more over the next 3 months.	**TRADING SELL:** The industry, as defined by the analyst's coverage universe, is expected to underperform the relevant primary market index over the next 3 months.

** This framework only applies to stocks listed on the Singapore Stock Exchange, Bursa Malaysia, Stock Exchange of Thailand and Jakarta Stock Exchange. Occasionally, it is permitted for the total expected returns to be temporarily outside the prescribed ranges due to extreme market volatility or other justifiable company or industry-specific reasons.*

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RECOMMENDATION FRAMEWORK #2 **

STOCK RECOMMENDATIONS	SECTOR RECOMMENDATIONS
OUTPERFORM: Expected positive total returns of 15% or more over the next 12 months.	**OVERWEIGHT:** The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of +15% or better over the next 12 months.
NEUTRAL: Expected total returns of between -15% and +15% over the next 12 months.	**NEUTRAL:** The industry, as defined by the analyst's coverage universe, has either (i) an equal number of stocks that are expected to have total returns of +15% (or better) or -15% (or worse), or (ii) stocks that are predominantly expected to have total returns that will range from +15% to -15%; both over the next 12 months.
UNDERPERFORM: Expected negative total returns of 15% or more over the next 12 months.	**UNDERWEIGHT:** The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of -15% or worse over the next 12 months.
TRADING BUY: Expected positive total returns of 15% or more over the next 3 months.	**TRADING BUY:** The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of +15% or better over the next 3 months.
TRADING SELL: Expected negative total returns of 15% or more over the next 3 months.	**TRADING SELL:** The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of -15% or worse over the next 3 months.

*** This framework only applies to stocks listed on the Hong Kong Stock Exchange and China listings on the Singapore Stock Exchange. Occasionally, it is permitted for the total expected returns to be temporarily outside the prescribed ranges due to extreme market volatility or other justifiable company or industry-specific reasons.*