AmResearch

Company report

HARTALEGA

(HART MK, HTHB.KL)

22 November 2012

Leveraging on its technological capabilities

HOLD

(Initiation)

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Rationale for report: Initiation Coverage

Price	RM4.90
Fair Value	RM5.10
52-week High/Low	RM5.06/RM2.76

Key Changes

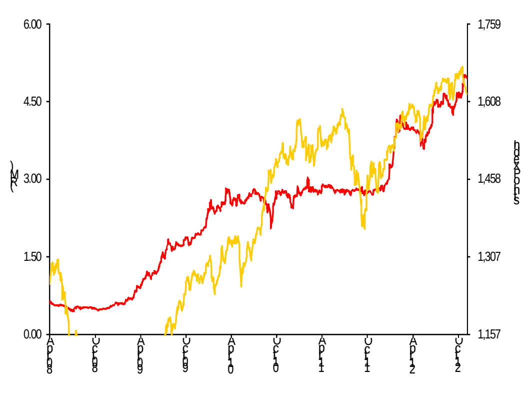
Fair value	Initiation
EPS	Initiation

YE to Mar	FY12	FY13F	FY14F	FY15F
Revenue (RMmil)	931.1	1,025.0	1,341.4	1,639.3
Core net profit (RMmil)	201.4	226.7	300.5	380.0
FD EPS (Sen)	25.0	28.2	37.3	47.2
EPS growth (%)	n/a	12.6	32.5	26.5
Consensus EPS (Sen)	27.7	31.2	35.5	39.4
FD DPS (Sen)	11.3	13.0	17.0	21.0
PE (x)	19.6	17.4	13.1	10.4
EV/EBITDA (x)	13.3	12.0	9.2	7.2
Div yield (%)	2.3	2.6	3.4	4.2
ROE (%)	36.2	33.2	35.8	36.4
Net Gearing (%)	n/a	n/a	10.2	6.3

Stock and Financial Data

Shares Outstanding (million)	731.8
Market Cap (RMmil)	3,585.8
Book value (RM/share)	0.77
P/BV (x)	6.4
ROE (%)	36.2
Net Gearing (%)	Net Cash
Major Shareholders	Hartalega Industries Sdn Bhd (27.6%) Franklin Resources (0.6%)
Free Float (%)	71.6
Avg Daily Value (RMmil)	1.3

Price performance	3mth	6mth	12mth
Absolute (%)	5.4	32.6	75.0
Relative (%)	7.1	25.7	54.6



Investment Highlights

- **We initiate coverage on Hartalega Holdings Bhd (Hartalega), with a HOLD recommendation on a fair value of RM5.10/share. This is based on a target PE of 14x FY14F earnings (2SD above its 3-year mean).**

- **We like Hartalega due to:- (1) its dominance in the higher-margin nitrile segment; (2) its ability to develop proprietary technology which translates into greater operating efficiencies; (3) potential growth from the emerging markets via its new OBM strategy; and (4) increasing foreign interest (15% currently vs. 10% in May 2012).**

- **At present, Hartalega has 6% of the global rubber glove market share and 13% of the nitrile glove segment. Its current capacity of 10.8bil pieces per annum will be boosted by 39% once Plant 6 is fully commissioned by July 2013. Having commenced operations at end-Sept 2012, we reckon that Plant 6 could contribute RM14mil to FY13F's net profit.**

- **Going forward, Hartalega's growth hinges on its Next Generation Integrated Glove Manufacturing Complex (NGC). This RM1.5bil, 8-year investment will see installed capacity grow to 43bil pieces by FY22, contributed by 72 lines from 6 new plants. (10-year CAGR of 16%). We believe that operating costs could be shaved by ~12% (2% per plant).**

- **Hartalega currently enjoys the highest EBITDA margin in the industry. At 31%, it is roughly double that of the other 3 major players'. This can be attributed to its high productivity operations from in-house engineering and innovative culture (average line capacity of 133 pcs/yr/line vs.the industry's 91 pcs/yr/line). In addition, nitrile enjoys an intrinsic pricing advantage over natural rubber (discount to latex of 12%).**

- **We forecast Hartalega's net profit to expand by 11% from RM201mil in FY12 to RM228mil in FY13F. Earnings are expected to accelerate by 30% in FY14F to RM306mil, boosted by new capacity and cost savings from NGC. Our estimates are based on our view of stable latex and butadiene prices (RM6.50/kg; USD1,400/tonne), capacity utilisation of 88% and ASP of RM105.**

- **Key risks to the stock include delays in NGC commissioning, nitrile glove overcapacity in 2HCY13 and Hartalega's concentrated customers (top 2 customers buy 44% of products).**

- **Hartalega has a policy of paying out 45% of its earnings as dividends. With that as a guide, we forecast gross DPS of 13 sen and 16.5 sen for FY13F and FY14F, respectively. This translates into dividend yields of 2.6%-4.2%.**

- **While we see value in the company, we believe our HOLD rating is justified given the limited upside potential in the near term. The stock has appreciated 75% YTD, outperforming the FBM KLCI by 68ppts. It is currently trading slightly below its all-time high, at a PE of 17x.**

PP 12247/06/2013 (032380)

INITIATE COVERAGE WITH A HOLD

We initiate coverage on Hartalega Holdings Bhd (Hartalega), with a HOLD recommendation on a fair value of RM5.10/share.

This is based on a target PE of 14x FY14F earnings, 2SD above its 3-year mean.

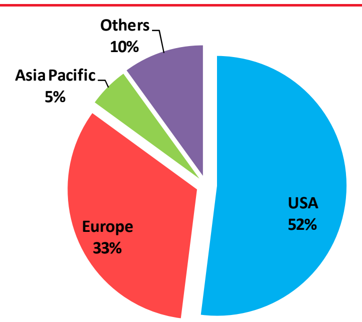
COMPANY BACKGROUND

Established in 1988, Hartalega Holdings Bhd was listed on the Main Board of Bursa Malaysia in 2008. Its principal activity is the manufacturing of rubber examination gloves and it is currently the world's largest nitrile glove producer, with a 13% global market share.

Hartalega's impressive rise to the top of the global nitrile glove market and to being the most efficient glove maker can be attributed to its culture of innovation and technological advancement.

At present, Hartalega exports its products to 39 countries and has a customer base of 137 customers. As its niche is in the premium nitrile glove segment, developed and quality demanding markets such as the United States, Europe/Scandinavia and Australia take up the bulk of its exports.

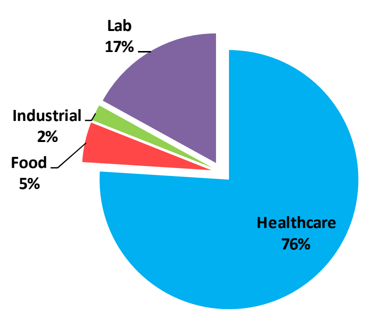
CHART 1 : CUSTOMERS BY GEOGRAPHY



Source: Company / AmResearch

About 75% of its sales are to the healthcare industry, whereby demand is inelastic.

CHART 2 : CUSTOMERS BY SEGMENTS



Source: Company / AmResearch

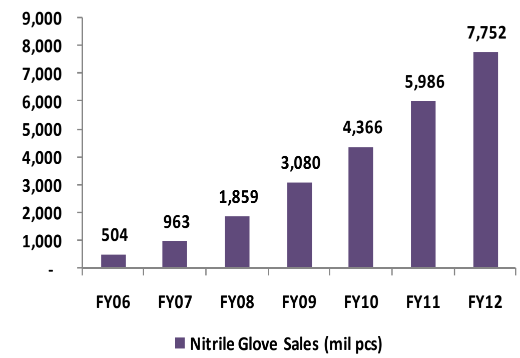
WORLD'S LARGEST NITRILE GLOVE MAKER

❑ *6% of world market share, 13% of nitrile segment*

In FY12, Hartalega produced a total of 8.2bil pieces of rubber gloves, making up 5.5% of global rubber glove consumption of 148bil pieces.

In the nitrile segment specifically, Hartalega commanded 13% of the international nitrile glove consumption of 60bil pieces, producing 7.8bil pieces of gloves. About 95% of its production lines are dedicated to nitrile gloves with the remaining for powder-free latex gloves.

CHART 3 : NITRILE GLOVE SALES



Source: Company / AmResearch

❑ *Many smaller rivals*

We gather that Hartalega's closest rivals, namely YTY Group (privately-held Malaysian glove manufacturer), Kimberly-Clark and Smartgloves, each produces less than 10% of the global demand for nitrile gloves.

Having said that, with many glove manufacturers having invested in expanding their nitrile glove capacity since 2010, we believe Hartalega's share of the pie could be shrinking in the medium term, unless it invests to stay ahead.

AGGRESSIVE CAPACITY EXPANSION TO FURTHER CEMENT POSITION

❑ *Plant 6 to boost capacity by 39%*

At present, Hartalega has 5 plants at Bestari Jaya with an installed capacity of 10.8bil pieces per annum (recently upgraded from 9.8bil pieces per annum).

In February 2012, Hartalega began construction of Plant 6. Capacity is expected to be boosted by 39% (3.9bil pieces per annum) once it is fully commissioned.

Operations commenced in October 2012 with 2 out of the 10 production lines being commissioned (line speed of 45,000 pieces per hour). The remaining 8 will be commissioned progressively, with the target of 1 line (32.4mil pieces) per month until completion in July 2013.

We reckon that the new supply coming upstream from Plant 6 could contribute ~RM14mil to its FY13F's net profit.

❑ *NGC, the next growth phase*

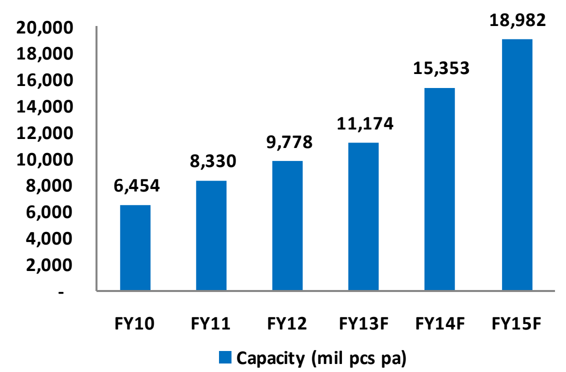
Hartalega's future growth hinges on the development of its Next Generation Integrated Glove Manufacturing Complex (NGC).

This RM1.5bil, 8-year investment will see installed capacity grow to 43bil pieces by FY22, contributed by 72 lines from 6 new plants (production capacity 10-year CAGR of 16%). Construction will be split into two 4-year phases.

Hartalega has identified a 112-acre parcel of land (3 times its current land size) in Sepang for the construction of the 6 plants as well as other integrated glove manufacturing facilities (R&D centre, renewable energy complex and workers quarters).

We understand that the company is currently in the process of signing the land sales and purchase agreement and seeking the relevant state authorities' approvals.

CHART 4 : CAPACITY EXPANSION (WITH NGC CAPACITY FROM FY14F)



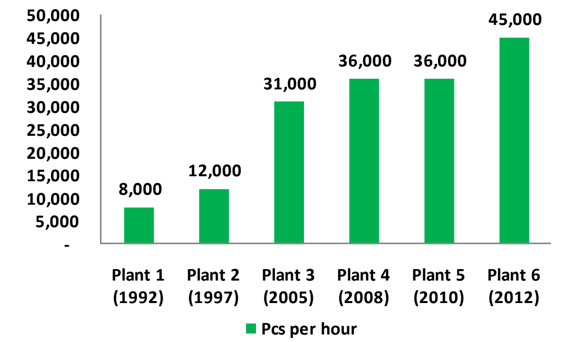
Source: Company / AmResearch

EFFICIENT MANUFACTURING

Hartalega is known as the most technologically advanced glove producer. Its in-house engineering capabilities and innovative culture has led it to develop various machineries that have become the staple in its competitors' factories.

For example, Hartalega owns the patent to the double former production line, which enables it to have the highest production capacity in the world – ~30,000 pieces/hour. Since then, it has only gotten better. Production lines are now capable of manufacturing up to 45,000 pieces/hour. In contrast, the industry's average is 26,000 pieces/hour.

CHART 5 : LINE SPEEDS AT ITS 6 PLANTS



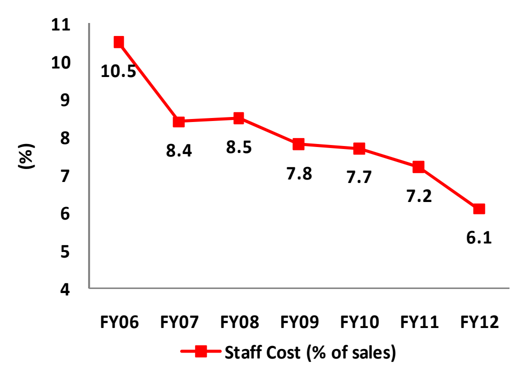
Source: Company / AmResearch

❑ *Engineering expertise keeping it one-step ahead*

While most of its peers have just begun investing more in automation, Hartalega has used its proprietary technology for glove removal and stacking since 1995. Together with packaging, stacking is the most labour-intensive part of production.

Its highly automated production processes have enabled it to trim its staff costs over the years. From FY06 to FY12, the ratio of skilled workforce to total workforce increased from 21% to 35%. Upon the completion of NGC, the proportion would be 51%.

CHART 6 : DECLINING STAFF COSTS (% OF SALES)



Source: Company / AmResearch

As such, we reckon that it will be the least impacted when the minimum wage (RM900/worker in Peninsular Malaysia) takes effect in January 2013.

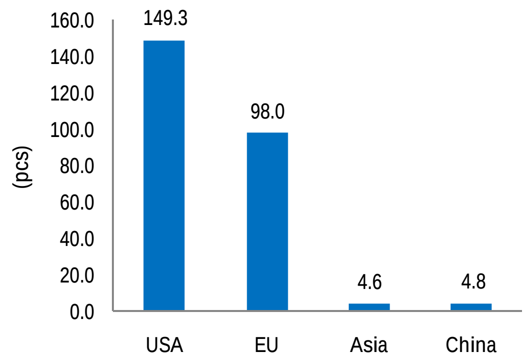
We estimate its net profit could be trimmed by 3%. However, we are not too concerned given that Hartalega will be introducing new proprietary technology for the packaging and quality control departments within the next 2 years.

LONGER TERM GROWTH PLANS

❑ *Emerging markets the next frontier*

The average consumption of gloves per capita in the Asian region (ex-Japan) is less than 10 pieces per annum, a stark contrast to the 100 pieces per annum in developed countries.

CHART 7 : GLOVE CONSUMPTION PER CAPITA



Source: Company / AmResearch

As countries in this region are quite populous (China, India and Indonesia alone make up 40% of world population), glove demand growth could potentially be exponential, even more so as more governments launch sweeping healthcare reforms in their respective countries.

For instance, under the “Healthy China 2020” programme, China’s Ministry of Health targets to overhaul its healthcare system and provide universal healthcare with equal access to its citizens by 2020. To put things into perspective, the China market alone could be as large as 2011’s global glove consumption of 150bil pieces.

- ***Branding its way forward***

To penetrate these countries, Hartalega will be looking at adopting the OBM business model. As such, the company is currently embarking on a corporate and product branding exercise, which will cost around RM2.5mil for the next 5 years.

It will create the “GloveOn” brand as a means to sell its gloves in Asia to avoid cannibalisation and direct competition with its OEM customers. Its established “Pharmatex” brand will continue to be its glove and other medical supplies distributor.

CHART 8 : LOCATION OF ITS OVERSEAS OPERATIONS (UNDER ITS PHARMATEX BRAND)

Source: Company / AmResearch

While we believe that rising disposable income in the 3 major developing countries would also lead to an upward migration of glove types, we believe that the demand will be mostly for natural rubber gloves due to customer’s price sensitivity.

KEY RISKS TO THE STOCK

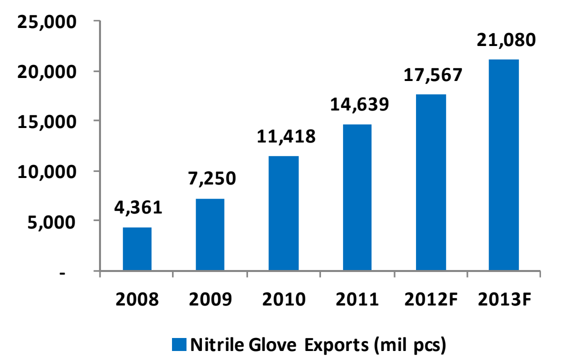
- ***Nitrile glove overcapacity***

We reckon that concerns over a nitrile glove supply glut in the near term may be justified.

Many manufacturers have jumped onto the nitrile bandwagon in the past 2 years and having factored in delays in plant commissioning and governmental approvals, we expect to see these new supplies coming onboard by 2HCY13.

Based on MREPC’s projected 20% growth in nitrile glove exports from Malaysia for 2012 and extrapolating for 2013, the additional export demand would be roughly 6.4bil pieces for both years. The global nitrile market will see a rise in consumption of 10bil pieces to 70bil pieces in 2013.

CHART 9 : MALAYSIA’S NITRILE GLOVE EXPORTS BY VOLUME



Source: MREPC/ AmResearch

As it is, Hartalega’s calendarised expansion plans will bring onstream an additional 3.5bil pieces by end-2013. This would have made up half of the extra demand even without taking into account Supermax’s (+5.2bil pieces by 2013) or Top Glove’s (+3.3bil pieces) nitrile glove expansion plans.

With price competition possibly coming into play in 2HCY13, we caution that Hartalega’s margins could be slightly compressed given its sales mix of ~95% nitrile gloves.

Nonetheless, our back-of-envelope calculations show that with every new plant, Hartalega can shed up to 2% off its production costs (mainly from overheads). As such, EBITDA margins should remain intact.

- ***Setbacks in NGC will cloud growth***

Although we welcome Hartalega’s bold capacity expansion plan, we warn of similar postponement issues faced by Supermax’s Glove City. Announced back in CY09, Glove City has yet to take off due to infrastructure limitations.

Hartalega is cognisant of such issues and has come up with a backup plan to ensure the capacity expansion plans will not be held back. The arrangement will see the complex's 2 phases be constructed on 2 separate plots of land. It has identified a 50 acre-land near its current factories, where Phase 1 may be constructed.

Should nitrile glove demand continue to grow rapidly (+29% in 2011), management hinted that they will be able to expedite the NGC programme from 8 years to 6 years by building concurrently instead of progressively.

All in, we believe 2HCY13 will be a challenging year for Hartalega as it will not be building production lines in 2HCY13 as it begins construction of NGC and complete Plant 6 in July 2013. This is in spite of it having sold out slightly more than half of Plant 6's capacity.

- ***Customers are too concentrated***

In spite of having dealt with 130 clients, only 40 customers can be considered active.

Hartalega's top 2 purchasers, Medline (world's largest medical supplies distributor) and Paul Hartmann (from Germany), make up more than 40% of its total sales whereas its other customers contribute less than 5% each to Hartalega's topline.

The company supplies ~70% of Medline's rubber glove sales and have a reciprocal reliant relationship.

In contrast, Top Glove sells to 1,000 customers in 185 countries. No one customer makes up more than 4% of its revenue.

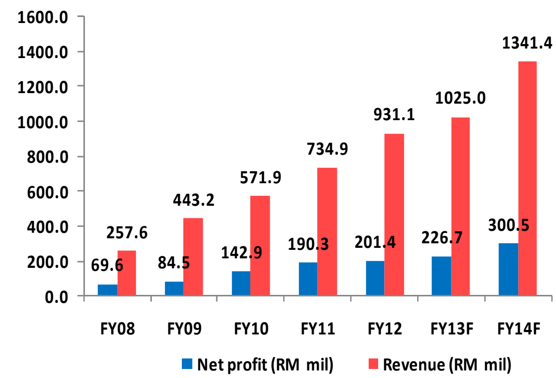
FINANCIALS

- ***Net profit to grow 11% in FY13F and accelerate by 30% in FY14F***

We forecast Hartalega's net profit to expand by 13% from RM201mil in FY12 to RM227mil in FY13F. In FY14F, earnings are expected to accelerate by 33% to RM300mil, boosted by new capacity and cost savings from NGC.

Our estimates are premised on our view of latex and nitrile prices of RM6.50/kg and USD1,400/tonne, capacity utilisation of 88% and ASPs of RM104 for FY13F and RM100 for FY14F. These historically low ASPs take into account the possibility of a price competition beginning in 2HCY13.

CHART 10 : HARTALEGA'S NET PROFIT AND REVENUE



Source: Company / AmResearch

- ***Declining costs?***

Nitrile prices have been on a decline since peaking at USD2,200 in August 2011 (YTD: -11%). We expect prices to stabilise around USD1,400/tone in the coming quarters. With raw materials making up more than half of Hartalega's costs, any decline would greatly contribute to its margins. (EBITDA margin was up 2ppts to 30% in 1H13 vs. FY12's average of 28%).

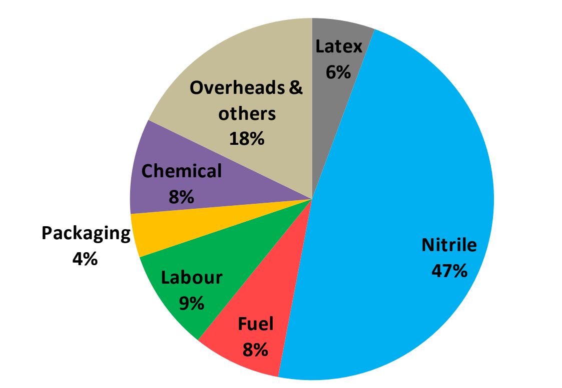
Fuel expenses, which account for ~8% of production expenses, are expected to rise given the pullback in natural gas subsidies and uncertain supply. To guard against this possibility, Hartalega is ramping up its utilisation of biomass as an alternative.

At present, it has only one 26MW biomass plant, contributing 10% of its energy usage (remaining 90% being natural gas). We understand that this is due to the high outlay (RM5mil/furnace) and the huge land space needed to store the palm waste. With the higher labour and maintenance costs for biomass, we believe that the cost differential is now quite insignificant.

Moving forward, we could potentially see a drop in labour, packaging and overheads expenditure as more processes are mechanised and efficiency is increased. In addition, with higher capacities, Hartalega would be able to benefit from greater economies of scale.

In any case, glove manufacturers may pass down any cost increase to their customers. We gather that Hartalega's average cost pass-through is ~80%.

CHART 11 : BREAKDOWN OF PRODUCTION COSTS



Source: Company / AmResearch

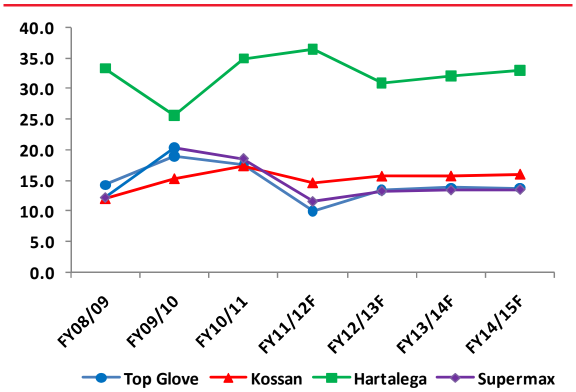
❑ *Highest EBITDA margin in industry*

Hartalega's high productivity operations have enabled it to enjoy the highest EBITDA margins in the industry. At 31% (FY12), it is roughly double that of the other 3 major players' average of 14%.

Besides the greater operating efficiency, its low cost per glove can be attributed to the fact that nitrile enjoys an intrinsic pricing advantage over natural rubber. In Nov 2012, nitrile's discount to latex was 9%.

Going forward, we expect nitrile prices to stabilise at USD1,400/tonne. This will provide pricing stability to customers and have a positive impact on margins as raw materials comprise more than 50% of Hartalega's production costs.

CHART 12 : EBITDA MARGINS OF GLOVE MAKERS



Source: Companies / AmResearch

❑ *Investing for the future*

Based on management's guidance, we have raised Hartalega's capex to RM200mil, RM300mil and RM200mil for FY13F-FY15F, respectively, as Phase 1 of NGC takes shape.

This RM700mil will account for land acquisition (RM100mil), construction of Plant 7 and Plant 8 in FY14F and FY15F (RM200mil per plant) and infrastructure costs of RM200mil over FY13F-FY14F.

Management has indicated that it will accumulate a war chest of RM700mil from internal funds and draw down its working capital loans to cover the frontloaded capex of RM500mil for FY13F-FY14F with further expenditures to be funded internally by cash flows from Plant 7 onwards.

We deem this to be possible given its net cash position (FY13F: RM38mil) and very low gearing ratios of 0.1x in FY14F and FY15F. This is after including the capex projections. (To be conservative, we have not assumed full conversion of its warrants, unlike management's internal calculations).

❑ *Dividend policy*

Hartalega recently established a policy of paying out 45% of its earnings as dividends.

With that as a guide, we forecast gross DPS of 13 sen and 17 sen for FY13F and FY14F, respectively. At the current price, this translates into dividend yields of 2.6%-4.2%.

VALUATION AND RECOMMENDATION

While we see value in Hartalega, we believe our HOLD rating is justified given the limited upside potential in the near term.

The stock has appreciated 75% YTD, outperforming the FBM KLCI by 68ppts. It is currently trading slightly below its all-time high, at a PE of 17x.

Our fair value of RM5.10/share is based on a PE of 14x FY14F earnings – 2SD above its 3-yr mean of 11x.

We believe this slight premium is justified given:- (1) Hartalega's dominance in the higher-margin nitrile segment; (2) its ability to develop proprietary technology which translates into greater operating efficiencies; (3) potential growth from the emerging markets via its new OBM strategy; and (4) increasing foreign interests (15% currently from 10% in May 2012).

CHART 13 : PB BAND CHART

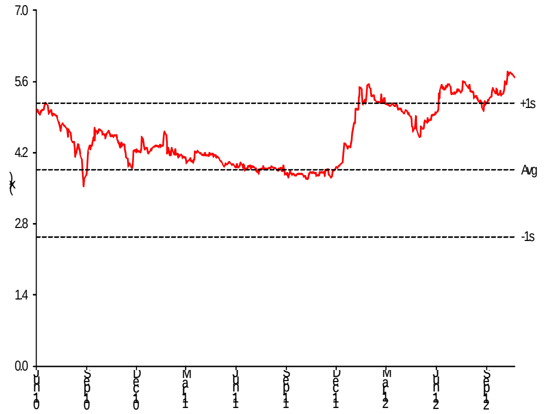


CHART 14 : PE BAND CHART

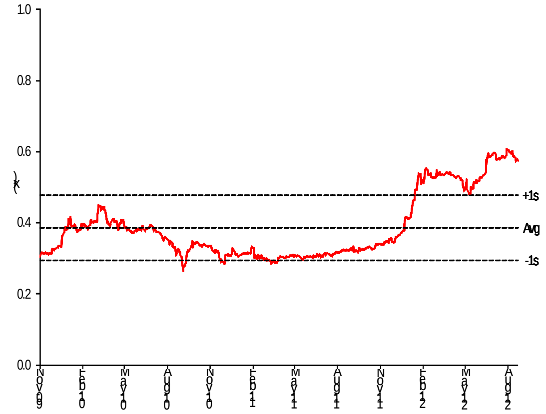


TABLE 1 : FINANCIAL DATA

Income Statement (RMmil, YE 31 Mar)	2011	2012	2013F	2014F	2015F
Revenue	734.9	931.1	1,025.0	1,341.4	1,639.3
EBITDA	268.2	288.2	328.6	443.3	566.7
Depreciation	(25.0)	(29.0)	(37.4)	(54.0)	(70.7)
Operating income (EBIT)	243.2	259.2	291.2	389	496.0
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	382.8	484.2
Taxation	(52.5)	(57.0)	(62.1)	(82.3)	(104.1)
Minorities/pref dividends	0.0	(0.1)	(0.1)	(0.1)	(0.1)
Net profit	190.3	201.4	226.7	300.5	380.0
Core net profit	190.3	201.4	226.7	300.5	380.0

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	123.0	269.4
Stock	64.7	97.5	107.4	132.7	149.7
Trade debtors	95.7	107.7	145.1	178.3	216.9
Other current assets	8.7	9.5	9.5	9.5	9.5
Total current assets	286.1	377.9	414.7	443.6	645.5
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	930.7	1,157.8
Minority interests	0.4	0.6	0.6	0.6	0.6
BV/share (RM)	0.68	0.77	0.93	1.16	1.44

Cash Flow (RMmil, YE 31 Mar)	2011	2012	2013F	2014F	2015F
Pretax profit	242.8	258.4	288.9	382.8	484.2
Depreciation	25.0	29.0	37.4	54.0	70.7
Net change in working capital	(40.9)	(44.5)	(36.0)	(52.7)	(41.7)
Others	(42.1)	(42.6)	(62.1)	(82.3)	(104.1)
Cash flow from operations	184.8	200.3	228.2	301.8	409.1
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)	(116.7)	(152.9)
Others	0.3	6.9	0.0	0.0	0.0
Cash flow from financing	(59.1)	(95.0)	(9.8)	(2.7)	(33.9)
Net cash flow	44.7	45.2	(11.6)	(30.7)	145.3
Net cash/(debt) b/f	47.2	59.7	(101.5)	(144.7)	26.3
Net cash/(debt) c/f	78.0	138.6	38.1	(105.6)	(78.3)

Key Ratios (YE 31 Mar)	2011	2012	2013F	2014F	2015F
Revenue growth (%)	28.5	26.7	10.1	30.9	22.2
EBITDA growth (%)	34.3	7.5	14.0	34.9	27.9
Pretax margins (%)	33.0	27.8	28.2	28.5	29.5
Net profit margins (%)	25.9	21.6	22.1	22.4	23.2
Interest cover (x)	98.5	149.3	83.6	45.4	34.4
Effective tax rate (%)	21.6	22.0	21.5	21.5	21.5
Net dividend payout (%)	40.1	45.3	46.1	45.5	44.5
Debtors turnover (days)	43	40	45	44	44
Stock turnover (days)	23	32	36	33	31
Creditors turnover (days)	14	13	13	12	12

Source: Company, AmResearch estimates

Published by

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Printed by

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