Gloves

Sector outlook - NEUTRAL

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Malaysia
Healthcare

Stock: Top Glove
Ticker: TOPG MK
Rec: O-PF
TP: RM5.90 (+12% TSR)

Stock: Hartalega
Ticker: HART MK
Rec: U-PF
TP: RM5.10 (+7% TSR)

Still in favour

The Malaysian glove sector is a cyclical sector leveraged to feedstock prices and demand-supply equilibrium. Both drivers moved favourably in 2012 leading to a re-rating of the sector from trough valuations. 2013 looks to be a year where latex prices will stay repressed given the oversupply issue while demand is still set to grow at 8-10% pa given the on-going restocking and switching from latex to nitrile gloves. However, this looks fully reflected in the share prices as Top Glove (O-PF) is trading at historical multiples and Hartalega (U-PF) is trading at a premium. We prefer Top Glove for the near term but Hartalega for the long run.

Feedstock prices

- Both latex and butadiene (nitrile glove feedstock) prices hit lows in 2012, which led to margin expansion for the glove makers.
- While this was largely due to an excess supply of latex in the market, deterioration in demand from the auto players was also a big factor particularly with butadiene.
- Our regional auto team expects a recovery in demand but this will affect butadiene prices more given the on-going excessive supply in latex.

Demand-supply equilibrium

- Demand for gloves is growing at 8-10%YoY but still being driven by demand for nitrile gloves given the on-going switching in the market.
- 2011 was a toxic mix of high latex price environment coupled with an overcapacity in the industry which led to de-stocking by the distributors.
- As ASPs have come down in 2012, re-stocking by the distributors was done in 2012 and this will continue in 2013 as we expect demand to continue to grow by 8-10%.

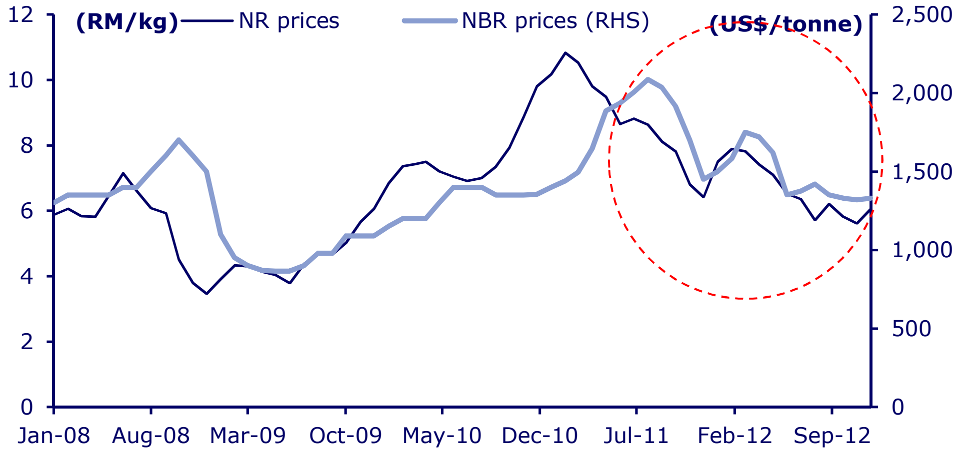
Weathering other concerns

- The biggest concern is with overcapacity in the nitrile segment as most manufacturers are adding capacity to tap into additional demand for nitrile. We estimate that demand will still outpace supply in 2013.
- Other concerns are with minimum wage implementation and rising fuel costs are unfounded given the pricing power the glove manufacturers possess.

Stock picks.

- Although the macro environment remains favourable, this is reflected in the share price of Hartalega while Top Glove has marginal upside.
- Our relative preference is for Top Glove (O-PF - TP RM5.90) as the biggest glove manufacturer globally and the company is continuing to see margin recovery.
- Hartalega is an U-PF (TP RM5.10) given multiples look fair as it means it is now trading in-line with Top Glove. NGC commissioning in 2014 will be the next leg up.

2012: A year of declining feedstock costs



Source: CLSA Asia-Pacific Markets

Prices hit a 3-year low in mid-2012

Auto makers saw a decline in demand in 2012 given poor economic growth

Recovery from auto makers in 2012

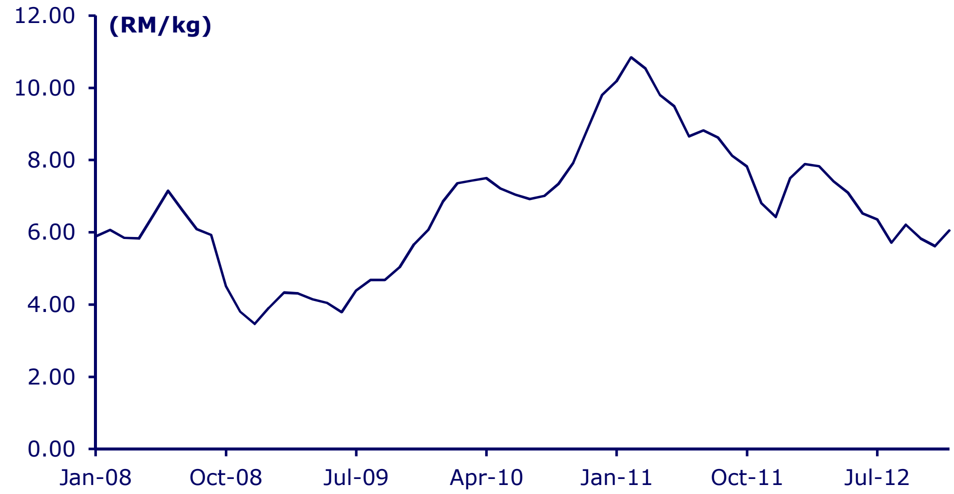
A recovery in the Japanese tyre market is forecast with uptrends noticed at year-end

Still in favour

After a spike in rubber prices in early 2011, rubber prices saw a correction and in 2012 remained at record low levels. This was bullish for natural rubber glove manufacturers which saw margins expand as latex makes up c. 55-60% of input costs.

Figure 1

5-year latex prices



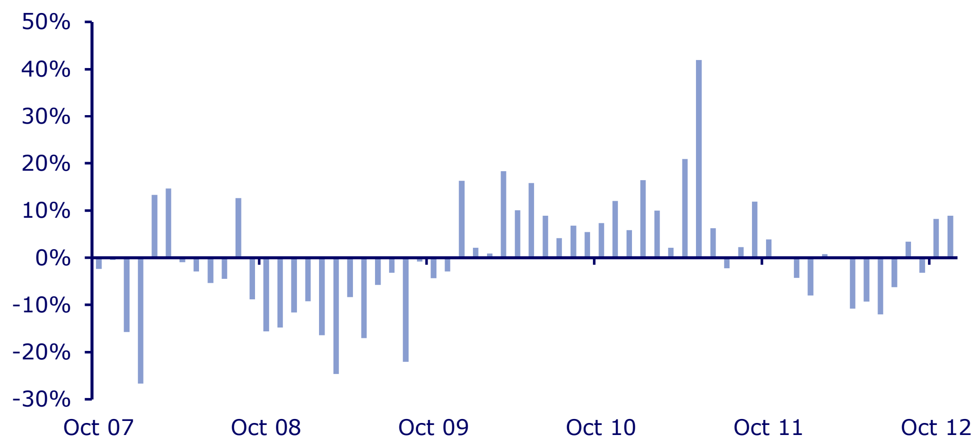
Source: Bloomberg

The largest consumer of latex in the world is in the auto industry which account for approximately 70% of the consumption of global natural rubber supply. In 2012, given the global economic down turn, there was deterioration in demand for automobiles and subsequently tires as well which led to the drop in rubber prices.

According to our Japanese tyre maker team, there are expectations for a recovery in the demand for tyres in 2013 given: 1) recovery signals in the US and Chinese tyre markets and 2) normalization of the Japanese market following the anti-Japanese fervour in China.

Figure 2

Japanese RE passenger vehicle tyre sales



Source: CLSA Asia-Pacific Markets, JATMA

Oversupply will mean additional demand should be easily absorbed

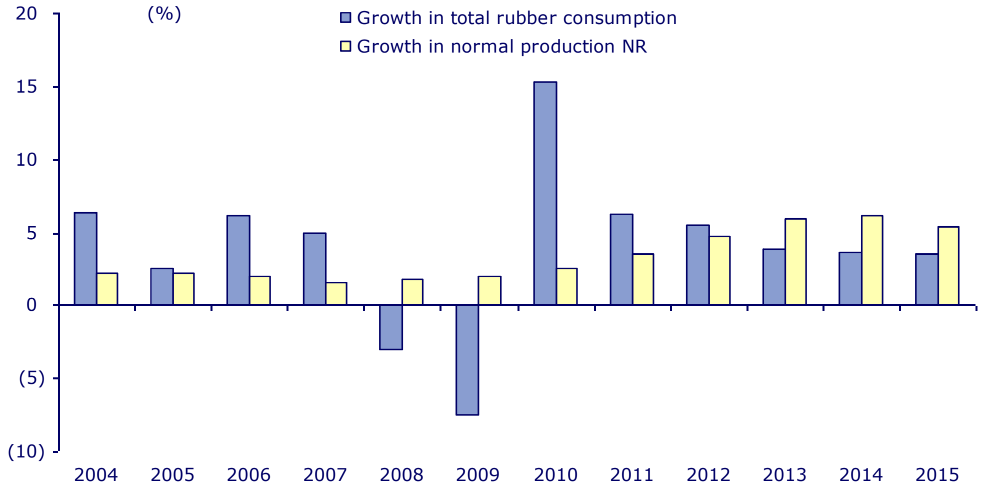
The implication for the recovery in auto demand is for a rise in latex prices in 2013, yet there is not an expectation for a significant rise. YTD latex prices have risen somewhat due to the traditional seasonality of prices given the wintering season.

However, given the surge of rubber tree planting in Thailand from 2005-2008 and the completion of their gestation period means that there is an overcapacity problem with natural rubber in the market currently.

Supply growth will start outpacing demand growth by 2H12

Figure 3

Total rubber consumption and production growth

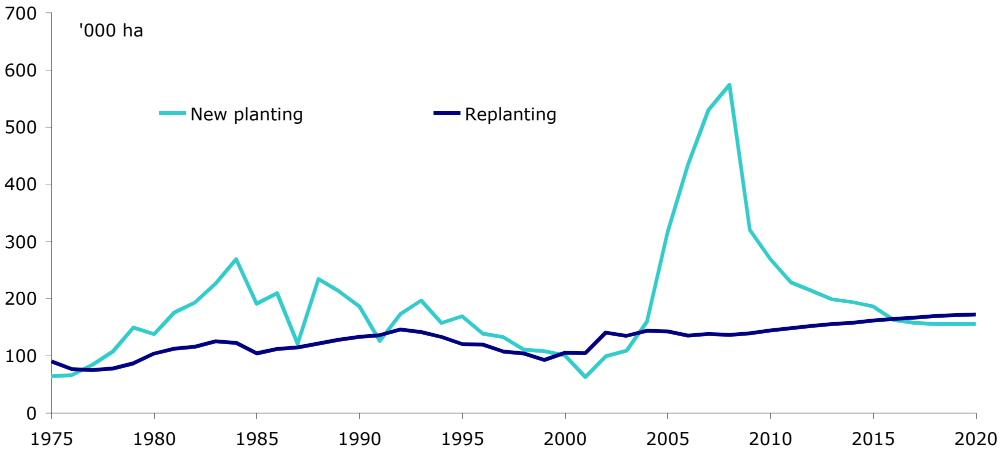


Source: Dr. Hidde Smit, CLSA Asia-Pacific Markets

Planting in Thailand from 2005-2008 will add to supply from 2013

Figure 4

Natural rubber planting – sum of 11 countries in Asia



Source: Dr. Hidde Smit, CLSA Asia-Pacific Markets

This is the main factor behind the current low rubber price environment which is expected to continue from 2013-2015 according to Dr. Hidde Smit, an industry expert on natural rubber.

Tough to control prices even with government intervention

Despite continued efforts by the governments of Thailand, Malaysia and Indonesia, rubber prices continue to remain at their lows given rubber is mostly produced by small farmer stakeholders as opposed to large companies meaning supply and demand is harder to control.

Expecting latex prices to trend at RM6.50-RM7 levels

This creates a bullish price environment for rubber glove makers over the next few years and means the recovery in margins is set to continue. We are expecting rubber prices to continue to trend between the RM6.50-RM7 levels from FY13-15CL.

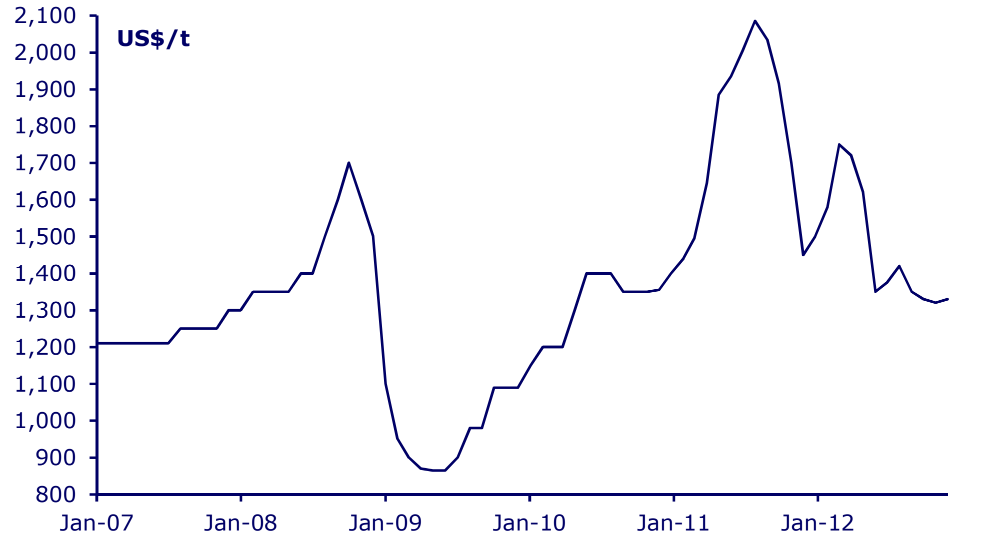
Butadiene prices

There is a different story in the butadiene (nitrile glove feedstock) market. Our regional petrochemicals team expect a rebound in butadiene prices having seen prices hit a two-year low back in November and expectations are for a recovery in Butadiene prices. The excess supply situation which exists in the latex market is not present in the butadiene market.

Hit lows in 2012 given low demand from auto players

Figure 5

Butadiene feedstock prices



Source: PLATTS, Hartalega

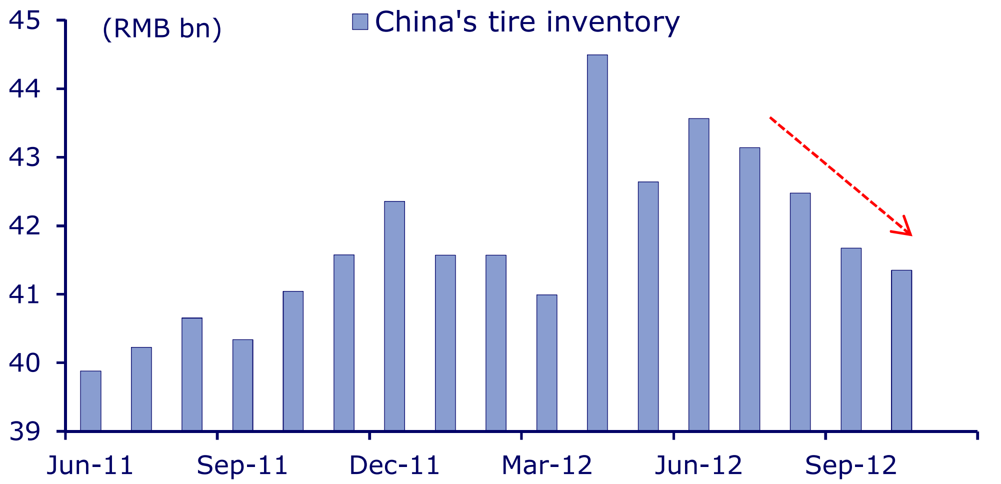
Demand from the Chinese tyre market will see butadiene price recovery

The return of demand from the auto players particularly in China will result in the recovery in the butadiene market. The recent under-performance of butadiene is mainly due to the negative impact of the territorial dispute between China and Japan which saw monthly Japanese passenger car sales slump resulting in a decline in butadiene production.

Declining Chinese tyre inventory means a pickup in demand will be followed by restocking

Figure 6

China: Tyre inventory



Source: CLSA Asia-Pacific Markets, CEIC

Our petrochemicals team expect the normalisation of demand for Japanese cars in China as well as demand coming back from auto makers to drive the recovery in butadiene prices. This is similar to guidance from the glove manufacturers whom are expecting a recovery.

Expectations for rising butadiene prices but will be passed on to the end user

Our butadiene expectations are for a recovery from the US$1.30 levels currently to US$1.60-2.00 from FY13-15CL. This will affect nitrile glove producers but expect them to pass on the additional costs to the customers as they have good pricing power.

Demand-supply equilibrium

Overcapacity situation has improved

The overcapacity situation in the industry has improved over the last two years as natural demand growth has offset some of the natural latex capacity added in 2009/10. Most of the overcapacity was in the powdered latex segment which saw declining demand as customers started switching to powder free and nitrile in developed markets and growth in emerging markets was not strong enough to offset the impact of declining demand from developed markets.

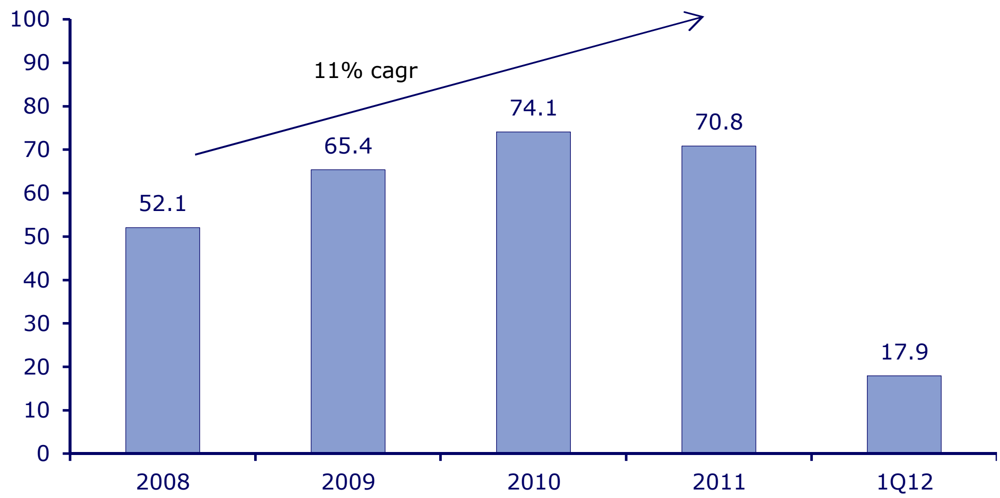
2011 was a period of destocking following record high latex prices

Malaysia rubber gloves exports saw very sharp expansion from 2H09 to 1H10 due to expectations of strong demand post H1N1 breakout. This resulted in a period of destocking of inventories after the outbreak subsided. Further, the inventory destocking period was coupled with extreme volatility in latex prices which caused distributors to postpone orders in expectations for lower prices.

Growing at a 11% Cagr despite the drop in exports in 2011

Figure 7

Malaysia Glove Exports



Source: MREPC

Reversal occurred in 2012 given the low price environment

This trend saw a reversal in 2012 as distributors started a period of restocking, taking advantage of the low ASP price environment, which saw growth trend back upwards to 8-10% growth which we expect to continue in 2013.

Switching to nitrile gloves continue to be prevalent

The switching from natural rubber (NR) gloves to nitrile or synthetic gloves (SR) given the allergens present in NR gloves continues to be prevalent. According to latest data from the Malaysian Rubber Export Promotion Council (MREPC), exports of SR gloves continue to grow at above 20%YoY while NR gloves are growing at c. 6%YoY.

We continue to expect synthetic rubber gloves to continue recording double digit growth in 2013 while expecting demand for NR gloves to pick up to as well given increasing healthcare awareness in emerging markets.

Weathering other concerns

Investors have on-going concerns in the nitrile glove segment at the prospect of a potential oversupply condition in the nitrile as most of the major glove manufacturers are adding capacity in the nitrile segment.

Capacity addition by major manufacturers have not been aggressive considering growth

Figure 8

Capacity addition by major players

(bn pieces)	2009	2010	2011	2012	2013	New additions from 11-13
Company						
Top Glove	31.5	33.8	40.1	40.3	45.1	5.1
Hartalega	6.4	7.6	9.5	10.7	13.4	3.9
Supermax	14.5	17.6	17.6	20.4	27.2	9.6
Latexx	4.5	6.0	9.0	11.0	12.0	3.0
Kossan	9.5	10.2	12.0	14.0	16.0	4.0
Total	**56.9**	**64.9**	**76.2**	**82.4**	**97.7**	**21.6**
Total new nitrile capacity (Assume 90% toward nitrile)						**19.4**
Nitrile capacity cagr (2010-13) by major manufacturers						**12%**
Annual glove demand growth (estimated)						**8-12%**
Annual nitrile demand growth (assuming shift from latex)						**20-25%**

Source: CLSA Asia-Pacific Markets, Top Glove, Hartalega, Supermax, Latexx, Kossan

Additional capacity should be absorbed by the market

Annual capacity additions of 14-15% previously should be easily absorbed by the market considering demand is running at 20-25%. However, 2013 additions is running at almost 17%YoY but important to consider that most of the glove manufacturers are running at almost full utilisation for their nitrile production lines.

Minimum wage hike and a possible gas price hike…

With the implementation of minimum wage from January and expectations for a gas price hike sometime in 2013, there is expected to be cost pressures affecting the glove manufacturers.

Additional costs will be passed on

This is unlikely as most manufacturers are looking at passing on additional costs resulting from the rise in wages to the end-user. Top Glove has already announced it will increase ASPs by 3-5% to account for the rise in these costs.

Glove demand remains inelastic despite the poor economic conditions and the glove manufacturers tend to pass on movements in costs to the end user. Their strong pricing power is a good tool to have in times of rising costs.

Automation of processes will reduce headcount too

The glove manufacturers are also looking at investing in automation which will reduce their headcount. Top Glove has said the automation of some of its processes will reduce headcount by 20% partially offsetting the impact of the minimum wage hike.

Automation will reduce headcount by 20% which will offset the impact of minimum wage hike

Figure 9

Top Glove: Move towards automation

Source: CLSA Asia-Pacific Markets, Top Glove

Same story with the fuel hike

There is also expected to be a fuel hike sometime in 2013 but it is not imminent until the general elections are completed. Nevertheless, we similarly expect the glove manufacturers to pass on any additional costs to the end user.

Stock picks

We initiate coverage on two of the sector's biggest players Top Glove (O-PF) and Hartalega (U-PF). In the space we prefer Top Glove for near term volume growth and continued margin expansion while Hartalega has the more promising long-term prospects.

Top Glove (O-PF)

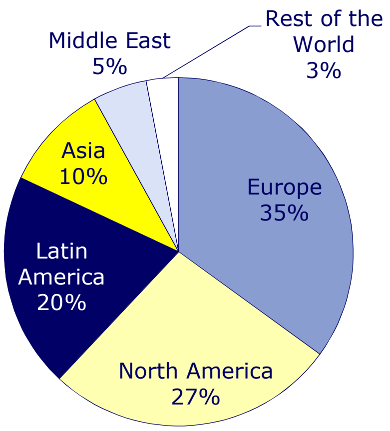
Top Glove is the biggest glove manufacturer in the world with c. 25% of global market share which it intends to grow to 30% by 2015. It has the capacity to produce c. 40bn pieces of gloves annually.

Sells mostly to developed nations but emerging markets growing steadily

The company sells its products mostly in developed markets such as Europe and the US but is seeing demand from the emerging markets as healthcare awareness grows.

Figure 10

Top Glove: Revenue by geography



Source: CLSA Asia-Pacific Markets

Ramping up capacity mostly in nitrile

In FY13 the company is expanding production by 4.8b pieces to cater for the additional demand for its nitrile glove segment where the company is growing volumes at 40%YoY.

Figure 11

TopGlove: Production capacity expansion plan

	Lines	Capacity (bn pcs p.a.)	Completion
Current			
22 glove factories	462	40.3	
Expansion plan			
F18	16	1.5	Apr-13
F25	20	1.8	Jun-13
F23	16	1.5	Aug-13
Total expansion	**52**	**4.8**	
Total Capacity	**514**	**45.1**	

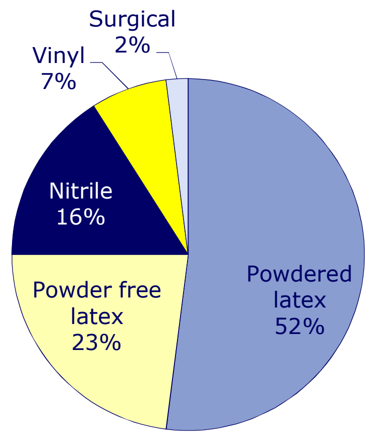
Source: Top Glove

Currently it is mainly a latex glove supplier which makes up approximately 75% of volumes sold but wants to increase its nitrile contribution which is currently 15% of volumes sold.

Seeking to grow nitrile contribution to top-line

Figure 12

Top Glove: 1Q13 Product mix by volume



Source: Top Glove

Moving upstream by acquiring land

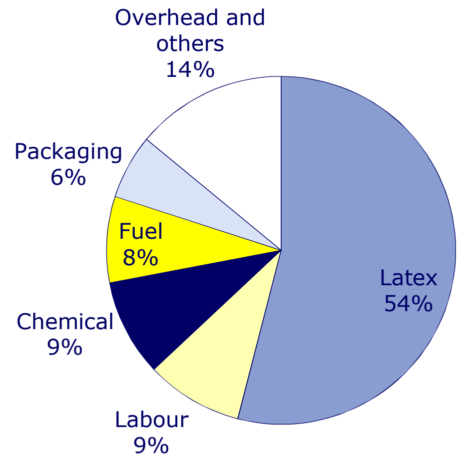
Additionally it is also moving upstream by acquiring a piece of green field land measuring 30,772ha for rubber plantations which it will use to mitigate the volatility in latex prices. This will be internally funded and will not be a drag on cash flow given the low investment cost of RM450m over 13 years.

Favourable latex environment is positive for the stock

The outlook looks favourable for the company given latex prices are expected to stay at current levels and this makes up the largest portion of Top Glove's operating costs at c. 54%.

Figure 13

Top Glove: Operating cost break down



Source: Top Glove

However, this looks fully reflected in the share price given multiples are trading at just a slight discount to historical averages.

Trading just a touch below 5-year averages

Figure 14

Top Glove: 5-year PE bands

Source: CLSA Asia-Pacific Markets

We ascribe a 15x PE multiple, based on the company's 5-year average, to CY2013 earnings to derive our RM5.90 TP which equates to a TSR of 12%

Hartalega (U-PF)

Hartalega is the biggest manufacturer of nitrile gloves in the world with an annual production capacity of 11bn pieces.

Most efficient glove maker

It is the most efficient glove maker and garners the highest margins amongst its peers as a result of efficiencies achieved in the production process via extensive R&D and a highly automated production process.

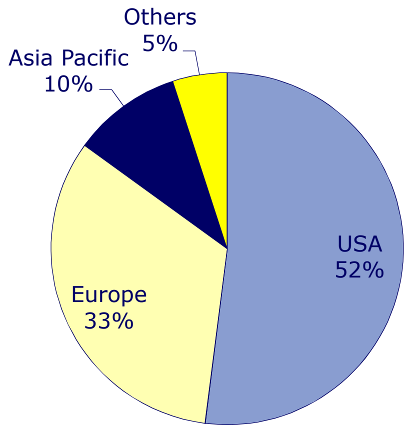
Almost all volume sold is in the nitrile segment

Given that almost all volumes sold is in the nitrile segment, most of its sales are to the developed markets of USA and Europe with small portion of sales coming from Asia.

85% of sales come from developed markets

Figure 15

Hartalega: Product sales by geography



Source: Hartalega

Superior net margins but this is set to come off as competition increases

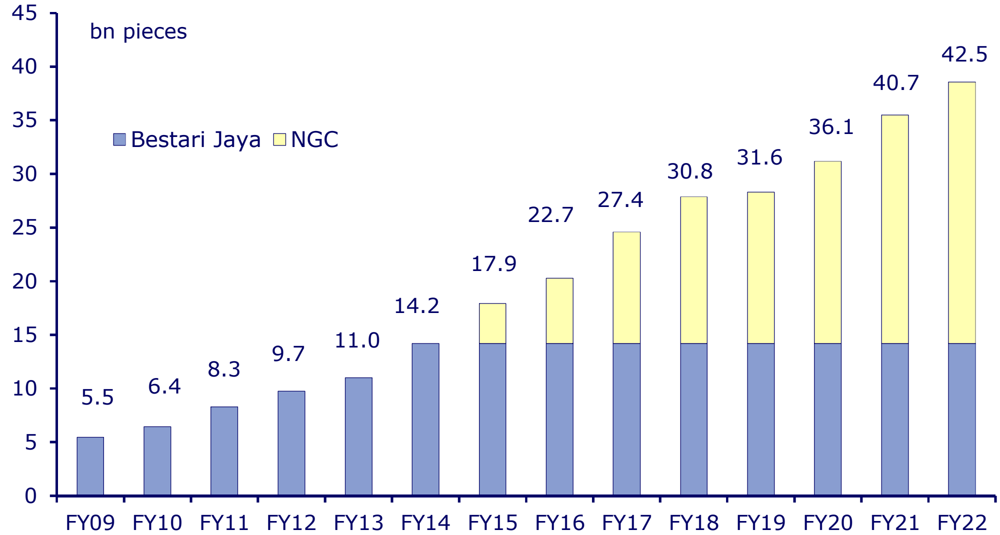
It has been generating superior margins to its peers with net margins of c. 22% versus peers at 10-12%. However, this is on a down trend as most of its competitors are increasing production of nitrile gloves and ASPs have been seeing pressure.

Hartalega is going to combat this with the construction of a RM1.5bn Next Generation Integrated Glove Manufacturing Complex which will increase its production capacity by 4x to 40bn pieces over 8 years. This will see it reduce cost/unit potentially as much as 5-6 ppts assuming constant ASPs.

NGC will be the game changer

Figure 16

Hartalega: Capacity additions (FY13-FY22)



Source: CLSA Asia-Pacific Markets, Hartalega

The company intends to focus on growing volumes and market share by passing on the entire savings to the customers which will see them reduce ASP's by as much as 12% to kill its competitors who are sitting on single digit margins.

The company has seen a huge re-rating from 8x in early 2011 to its current 14.7x valuations reflecting both its impressive efficiencies as a manufacturer and also its solid fundamentals.

A fully deserved re-rating

Figure 17

Hartalega: 5-year PE multiples

Source: CLSA Asia-Pacific Markets

Next leg up will be when NGC ramps up production

The next leg up for the stock will be the commissioning of the NGC which when Top Glove went through a similar capacity expansion, saw a multiple re-rating from 9x to 18x. A similar re-rating could be on the cards for Hartalega.

Fully valued at 14.7x FY14CL PE

Nevertheless, this is a 2014 story and for now, the stock looks to be fully valued at 14.7x FY14CL PE.

We apply a 15x multiple, which is Top Glove's 5-year average PE multiple, to Hartalega's CY2013 earnings to derive our RM5.10 TP which implies a TSR of 7%. We initiate with an U-PF call.

Figure 18

Gloves: Peer Comp

Name	BBG code	Mkt Cap (US$bil)	ADT (US$m)	PE		EPS Growth		ROE		Yield	PB
				CY12	CY13	CY12	CY13	CY12	CY13	CY12	CY12
Top Glove	TOPG MK Equity	1.1	1.5	14.0	12.4	12.7	12.6	3.6	2.4	3.2	2.6
Hartalega	HART MK Equity	1.2	0.4	15.0	13.7	9.0	10.0	3.1	4.6	2.7	5.1
Ansell	ANN AU Equity	1.9	9.4	15.2	12.7	12.5	11.6	2.7	2.6	2.4	3.0
Supermax	SUCB MK Equity	0.5	0.7	9.5	8.3	22.8	13.3	15.1	15.1	2.9	1.4
Kossan	KRI MK Equity	0.4	0.2	9.3	8.3	16.5	12.5	18.9	18.5	2.7	1.6

Source: CLSA Asia-Pacific Markets, Bloomberg Consensus Estimates for SUCB and KRI

Risks to the sector

The biggest risk is a sudden spike in feedstock prices, both nitrile and latex, will lead to an erosion of margins for both players as the manufacturers will find it difficult to pass on 100% of the costs to customers.

The other pertinent risk is a significant slowdown in demand for nitrile gloves given the capacity additions coming on-stream in this segment.

Companies mentioned

Hartalega (N-R)
Top Glove (N-R)

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.

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