Malaysia Company Focus
Hartalega Holdings Berhad

Bloomberg: HART MK EQUITY | Reuters: HTHB.KL

Refer to important disclosures at the end of this report

DBS Group Research . Equity

10 Jun 2013

BUY RM5.85 KLCI : 1,769.60

(Upgrade from Hold)

Price Target : 12-Month RM 6.60 (Prev RM 5.50)

Reason for Report : Raised earnings and TP, upgrade to BUY

Potential Catalyst: Demand growth in emerging markets

DBSV vs Consensus: Forecast EPS lower than consensus

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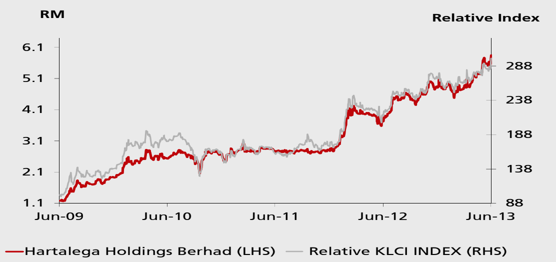
Price Relative



Forecasts and Valuation

FY Mar (RM m)	2013A	2014F	2015F	2016F
Revenue	1,032	1,248	1,471	1,700
EBITDA	336	377	450	520
Pre-tax Profit	306	340	398	453
Net Profit	235	262	302	344
Net Pft (Pre Ex.)	235	262	302	344
EPS (sen)	32.3	32.6	37.7	42.9
EPS Pre Ex. (sen)	32.3	32.6	37.7	42.9
EPS Gth (%)	11	1	16	14
EPS Gth Pre Ex (%)	11	1	16	14
Diluted EPS (sen)	32.3	32.6	37.7	42.9
Net DPS (sen)	14.5	14.7	17.0	19.3
BV Per Share (sen)	105.3	113.5	134.3	157.9
PE (X)	18.1	17.9	15.5	13.6
PE Pre Ex. (X)	18.1	17.9	15.5	13.6
P/Cash Flow (X)	13.4	13.6	13.2	11.6
EV/EBITDA (X)	12.2	11.9	9.9	8.4
Net Div Yield (%)	2.5	2.5	2.9	3.3
P/Book Value (X)	5.6	5.2	4.4	3.7
Net Debt/Equity (X)	CASH	CASH	CASH	CASH
ROAE (%)	33.9	31.2	30.5	29.4
Earnings Rev (%):		0.8	2.5	N/A
Consensus EPS (sen):		34.5	37.9	42.7
Other Broker Recs:		B: 9	S: 3	H: 7

ICB Industry : Health Care

ICB Sector: Health Care Equipment & Services

Principal Business: Latex examination gloves, nitrile gloves and technical rubber products manufacturer

Source of all data: Company, DBS Vickers, Bloomberg Finance L.P

Demand still strong

- **Improving line efficiency and robust demand for nitrile gloves to support margins**
- **Raised FY14-15F earnings by 1-3%; more upside if margins hold up**
- **Maintaining lead in nitrile gloves and line speed; further improvements possible**
- **Upgrade to BUY with higher RM6.60 TP**

Fencing off margin compression. We had previously raised concerns about new capacities and competition in the nitrile gloves space compressing margins. But that did not happen to Hartalega as it continues to improve production efficiency and sales volume continues to grow q-o-q, underpinned by strong demand for nitrile gloves.

More upside if margins hold up. We raised FY14-15F earnings by 1-3% to reflect better-than-expected margins but remain convinced that margins will be compressed due to competition. Assuming Hartalega is able to maintain pricing power and operating margins at current level of 30% vs our 27% assumptions, there may be 10% upside to our FY14-15F earnings.

Advancing innovation. Average line speed at factory 6 has reached 45,000 pieces/hour (fastest in the industry), but Hartalega will continue to enhance its manufacturing process through deeper automation. Its proprietary innovation in processes and products will ensure it remains the most profitable glove maker in town.

Upgrade to BUY. Our RM6.60 TP is pegged to 18x CY14EPS (fully diluted), similar to Top Glove's. It is currently trading at +2SD above historical mean, supported by consistent earnings delivery, highest margin (30% vs 12% peer average) and highest ROE (31% vs 17% peer average) in the sector. Its 45% dividend payout policy translates into c.3% net yield.

At A Glance

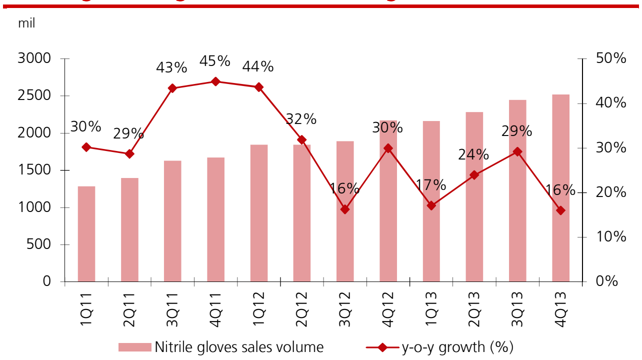
Issued Capital (m shrs)	734
Mkt. Cap (RMm/US$m)	4,294 / 1,393
Major Shareholders	
Hartalega Industries (%)	50.5
Free Float (%)	44.5
Avg. Daily Vol.('000)	661

Highlights

Robust demand for nitrile gloves driving capacity expansion. Demand for nitrile gloves continues to outpace latex gloves, and manufacturers (including Hartalega, Top Glove, Supermax and Kossan) continue to gear up nitrile gloves production capabilities. We had previously highlighted risk of margin compression from new capacities coming on stream that will intensify competition in the nitrile gloves space.

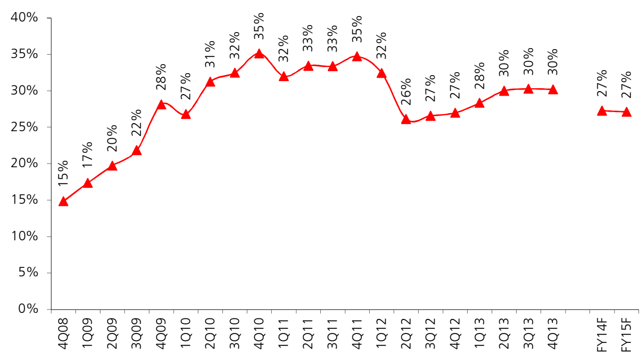
Hartalega has been able to defend margins so far. We did not see any margin compression at Hartalega, at least in the last six quarters. On the contrary, operating margins rose to 30% in 2QFY13 from 26% a year ago, and had hovered at c.30% in 3QFY13 and 4QFY13. The resilient margins were due to production efficiency and strong sales volume underpinned by strong demand for nitrile gloves.

Hartalega: Strong demand for nitrile gloves



Source: Company, DBS Vickers

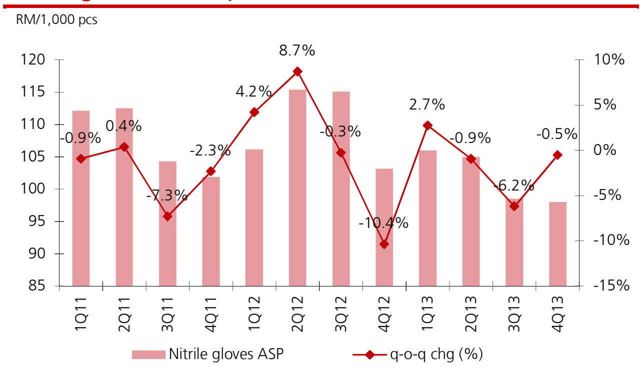
Hartalega: Operating margin held up since 2QFY12



Source: Company, DBS Vickers

Tweaked FY14-15F net profit by 1-3% to reflect higher margins but maintained our view that margins will be compressed going forward due to price competition. Hartalega's quarterly ASP (average selling prices) trend shows there were some pressure on ASP in the last four quarters. But that might have been due to Hartalega passing on lower raw material prices to customers. Nevertheless, there may be price competition as more nitrile capacities come on stream. We expect the top four glove manufacturers (Top Glove, Supermax, Hartalega and Kossan) to add a total of 14bn pieces (+18% y-o-y) of nitrile gloves capacity by end 2013. Hartalega may need to be content with lower margins over the longer term should it choose to price down ASP to protect or expand market share.

Hartalega: More ASP pressure ahead



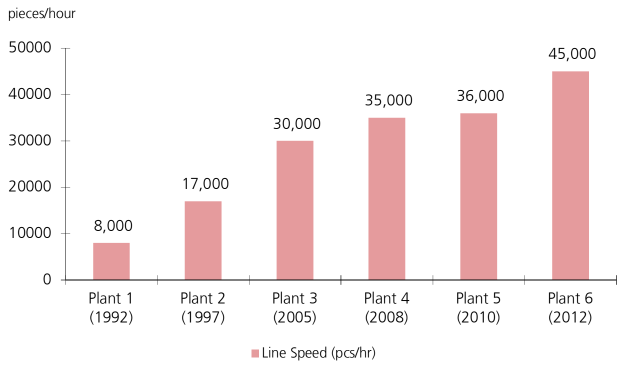
Source: Company, DBS Vickers

Our forecasts impute the following: 1) higher labour costs as a result of the minimum wage rule; 2) higher gas cost as we expect the government to gradually remove gas subsidies, and 3) lower latex prices (FY14-16F: RM5.80-6.40/kg). We expect nitrile raw material prices to remain relatively stable y-o-y (FY14-16F: RM4.40-4.50/kg).

There may be more upside if margins hold up. Our sensitivity analysis shows that every 1 ppt improvement in operating margin will lift net profit by c.5%. Assuming Hartalega is able to maintain its pricing power and operating margins at current level of c.30% vs our assumptions of 27%, there could be 10% upside to FY14-15F earnings.

Fastest line speed in the sector. Average line speed for factory 6 has reached 45,000 pieces/hour (fastest in the industry), but we understand it can improve further. Hartalega's track record shows that it usually creates a new milestone (in terms of line speed) each time it expands production capacity. We believe its innovative manufacturing process and products are the key differentiating factors that allow it to maintain cost efficiency and pricing power.

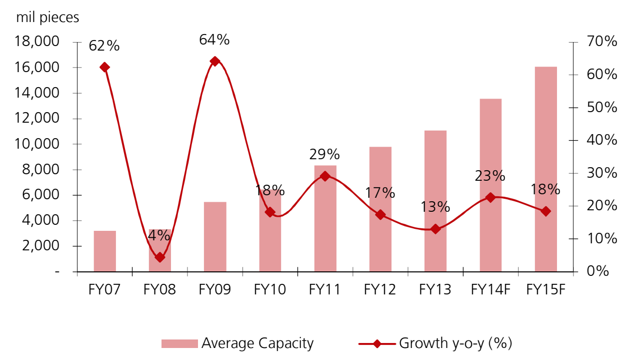
Hartalega: Fastest line speed in the sector



Source: Company

NGC is a long term value proposition. Future growth will be sustained by the Next Generation Integrated Glove Manufacturing Complex (NGC). The NGC project plans to add 28 billion pieces capacity over the next eight years. The entire project is expected to cost RM1.5-2.0bn (including RM100m land cost) and will lift total capacity to 42 billion pieces upon completion, targeted in 2022. Hartalega is in net cash position (RM170m) as of Mar-13.

Hartalega: Capacity growth



Source: Company, DBS Vickers

Factory 6 should be fully commissioned (all ten lines) in Jul-13. We understand the capacities in factory 6 are fully sold, indicating still strong demand for nitrile gloves.

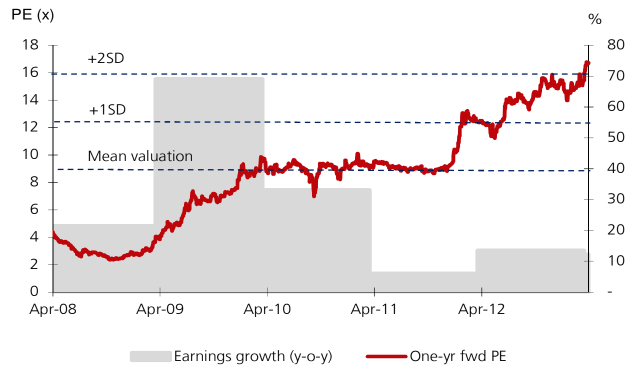
Capacity expansion schedule

	Production lines	Capacity (bn pcs)	Target completion
Current	45	10.0	
Factory 6 - nitrile	10	3.5	Jul 2013
Total	**55**	**13.5**	

Source: Company

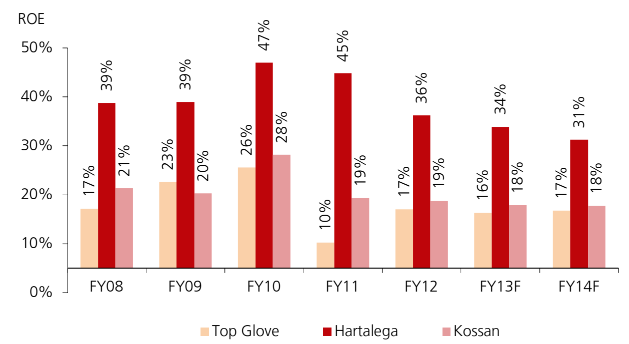
Upgrade to BUY with RM6.60 TP. Our TP is pegged to 18x CY14EPS (fully diluted basis). Hartalega's valuation at +2SD of historical mean is supported by consistent earnings delivery (14% earnings CAGR over FY13-15), highest operating margin (30% vs 12% peer average) and highest ROE (31% vs 17% peer average) in the sector.

Hartalega: Valuation vs earnings growth



Source: Company, DBS Vickers, Bloomberg

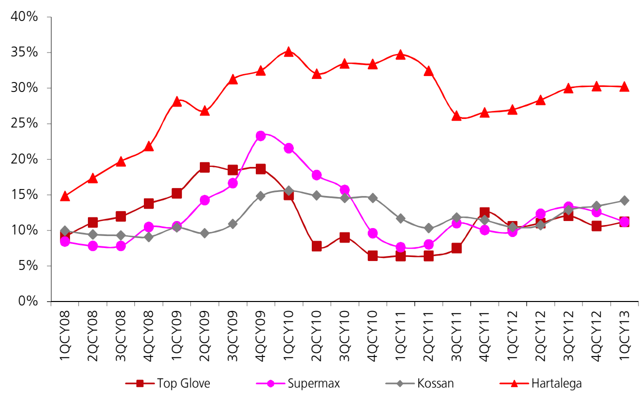
Hartalega offers the highest ROE in the sector



Hartalega's FY13 ROE is actual

Source: Companies, DBS Vickers

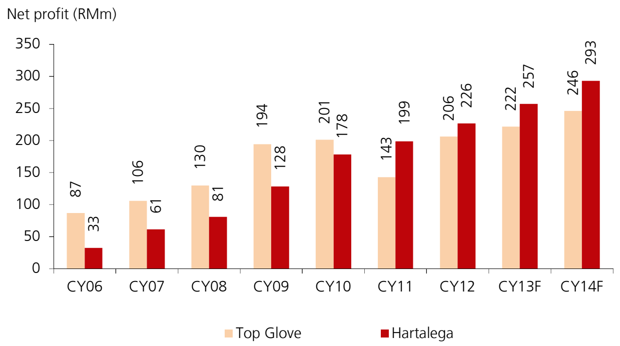
Hartalega's operating margin is the highest among peers



Source: Companies, DBS Vickers

Net profit base surpasses Top Glove's. Hartalega's net profit base (calenderised) has surpassed Top Glove's since 2011, despite having only one third of Top Glove's capacity. Given the larger profit base, Hartalega should trade at parity with Top Glove, in our view. Trading interests among foreign investors has improved with foreign shareholding rising from 10% in Feb-12 to 15.9% in Apr-13.

Hartalega's net profit surpass Top Glove



Based on calenderised earnings due to different FYE; Top Glove's FYE is Aug and Hartalega's FYE is Mar
Source: Companies, DBS Vickers

Adjusted for full dilution from conversion of free warrants. Hartalega's free warrants (73.4m) are exercisable from May-13 to May-15 (exercise period). Each free warrant is entitled to one new ordinary share (at an exercise price of RM4.14 per share) and any warrant not exercised during the exercise period will lapse. We have assumed full conversion of the warrants into ordinary shares in our forecasts and increased its share base by c.10%.

Key risks. Hartalega currently shines in production line speed and automation processes, but we do not discount other industry players catching up sooner or later. Risks to earnings are volatile raw material prices and USD currency. Raw material (nitrile and latex) comprised 50-60% of total production costs, and higher-than-expected raw material prices could erode margins. It is an industry practice to pass on increases in raw material prices to customers but the time taken to pass through all the costs depends on demand.

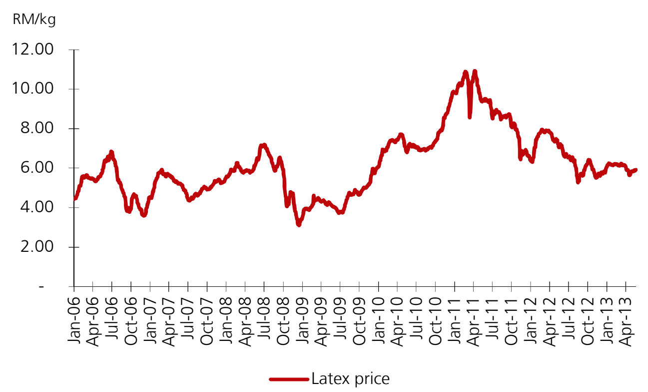
A weakening USD against Ringgit could reduce the value of Hartalega's exports and profits in Ringgit. Hartalega's hedging policy (for USD currency) is aligned with its receivables, which is approximately two to three months.

Peer comparison

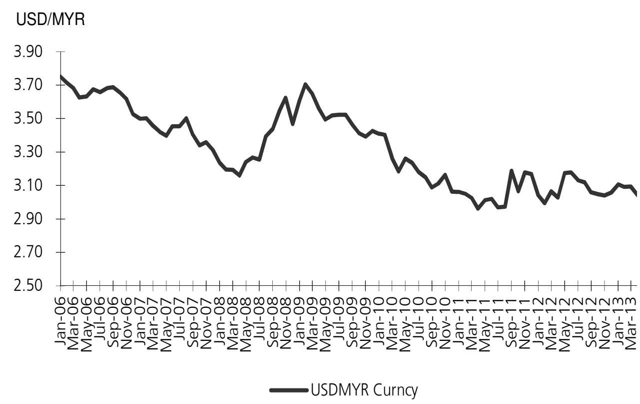
Company	Share Price (RM)	Target Price (RM)	Rating	Market Cap (US$m)	PE (x) CY12	PE (x) CY13	PE (x) CY14	P/BV (x)	Div Yield (%)	ROE (%)
Top Glove	6.52	7.20	BUY	1,317	19.6	18.2	16.4	2.9	2.7	16.3
Supermax	1.97	NA	NR	436	10.9	9.6	8.4	1.4	3.1	14.9
Kossan Rubber	4.38	4.50	BUY	455	13.4	11.8	10.3	1.8	4.1	17.8
Hartalega	5.85	6.60	BUY	1,399	18.9	18.3	16.5	5.2	2.5	31.2
Sector Average					**15.7**	**14.5**	**12.9**	**2.8**	**3.1**	**20.0**

Prices as of 6 Jun 2013
NA (not applicable); NR (not rated)
Source: Bloomberg, DBS Vickers

Latex price trend



Stronger USD/MYR will lift export revenue



Source: Bloomberg, DBS Vickers

Key Assumptions

FY Mar	2012A	2013A	2014F	2015F	2016F
Capacity (bln pcs)	9.8	11.1	13.6	16.1	18.6
Utilisation (%)	82.9	90.4	92.0	92.0	92.0
Nitrile latex (RM/kg)	4.7	4.4	4.4	4.4	4.5
NR latex (RM/kg)	8.3	6.3	6.4	6.1	5.8

Sensitivity Analysis

	2012
Nitrile costs +/- 1%	Net Profit +/- 1.8%
Energy costs +/- 1%	Net Profit +/- 0.2%

Segmental Breakdown

FY Mar	2012A	2013A	2014F	2015F	2016F
Revenues (RM m)					
North America	506	597	776	952	1,126
South America	11	14	18	23	28
Asia	106	105	116	133	153
Europe	281	283	297	312	327
Others	27	33	41	52	65
Total	**931**	**1,032**	**1,248**	**1,471**	**1,700**

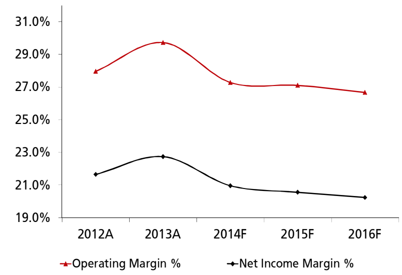
North America remained Hartalega's largest market (58% of total sales) but it is progressively making inroads in Asia (currently 10% of total sales).

Income Statement (RM m)

FY Mar	2012A	2013A	2014F	2015F	2016F
Revenue	931	1,032	1,248	1,471	1,700
Cost of Goods Sold	(673)	(731)	(913)	(1,078)	(1,252)
Gross Profit	**258**	**301**	**334**	**393**	**447**
Other Opng (Exp)/Inc	2	6	6	6	6
Operating Profit	**260**	**307**	**340**	**399**	**453**
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	0	0	0	0	0
Net Interest (Exp)/Inc	(2)	(1)	(1)	(1)	(1)
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	**259**	**306**	**340**	**398**	**453**
Tax	(57)	(71)	(78)	(96)	(109)
Minority Interest	0	0	0	0	0
Preference Dividend	0	0	0	0	0
Net Profit	**202**	**235**	**262**	**302**	**344**
Net Profit before Except.	202	235	262	302	344
EBITDA	281	336	377	450	520
Growth					
Revenue Gth (%)	26.7	10.8	20.9	17.9	15.6
EBITDA Gth (%)	5.9	19.4	12.4	19.4	15.4
Opg Profit Gth (%)	5.9	17.8	10.9	17.1	13.7
Net Profit Gth (%)	6.0	16.4	11.4	15.6	13.7
Margins & Ratio					
Gross Margins (%)	27.7	29.1	26.8	26.7	26.3
Opg Profit Margin (%)	28.0	29.7	27.3	27.1	26.7
Net Profit Margin (%)	21.7	22.7	21.0	20.6	20.2
ROAE (%)	36.2	33.9	31.2	30.5	29.4
ROA (%)	29.0	27.7	25.0	24.1	23.5
ROCE (%)	32.3	31.1	29.1	28.7	27.9
Div Payout Ratio (%)	45.3	45.0	45.0	45.0	45.0
Net Interest Cover (x)	149.9	339.7	570.4	668.1	759.8

Source: Company, DBS Vickers

Margins Trend

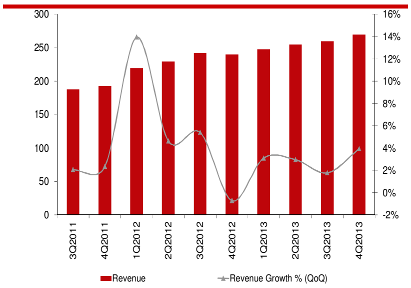


Competition in nitrile gloves will pressure margins, but enhanced productivity and efficiency will mitigate the impact.

Quarterly / Interim Income Statement (RM m)

FY Mar	4Q2012	1Q2013	2Q2013	3Q2013	4Q2013
Revenue	240	248	255	260	270
Cost of Goods Sold	(178)	(178)	(180)	(184)	(190)
Gross Profit	**63**	**70**	**75**	**76**	**80**
Other Oper. (Exp)/Inc	2	0	2	3	2
Operating Profit	**65**	**70**	**77**	**79**	**81**
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	0	0	0	0	0
Net Interest (Exp)/Inc	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	**64**	**70**	**76**	**78**	**81**
Tax	(14)	(16)	(18)	(18)	(19)
Minority Interest	0	0	0	0	0
Net Profit	**50**	**53**	**59**	**61**	**62**
Net profit bef Except.	50	53	59	61	62
EBITDA	65	70	77	79	81
Growth					
Revenue Gth (%)	(0.7)	3.1	3.0	1.8	3.9
EBITDA Gth (%)	0.9	8.3	9.0	2.7	3.7
Opg Profit Gth (%)	0.9	8.3	9.0	2.7	3.7
Net Profit Gth (%)	(1.4)	6.7	9.7	3.4	2.9
Margins					
Gross Margins (%)	26.1	28.3	29.4	29.3	29.5
Opg Profit Margins (%)	27.0	28.3	30.0	30.3	30.2
Net Profit Margins (%)	20.8	21.5	23.0	23.3	23.1

Revenue Trend



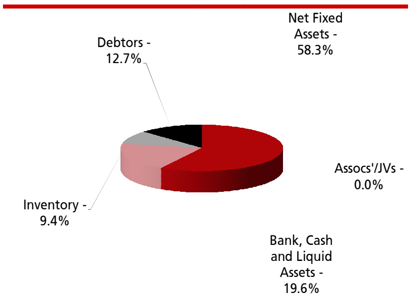
Sales volume inched up 2% q-o-q

ASP was flat in 4QFY13 as lower raw material costs were offset by higher wages. As a result, operating (EBIT) margin was stable q-o-q.

Balance Sheet (RM m)

FY Mar	2012A	2013A	2014F	2015F	2016F
Net Fixed Assets	380	535	668	787	891
Invts in Associates & JVs	0	0	0	0	0
Other LT Assets	0	8	8	8	8
Cash & ST Invts	163	182	225	258	323
Inventory	98	87	107	126	146
Debtors	108	120	145	171	198
Other Current Assets	10	5	5	5	5
Total Assets	**758**	**936**	**1,158**	**1,354**	**1,570**
ST Debt	13	8	8	8	8
Creditor	30	56	70	82	95
Other Current Liab	43	51	116	133	146
LT Debt	12	4	4	4	4
Other LT Liabilities	41	50	50	50	50
Shareholder's Equity	620	766	909	1,076	1,265
Minority Interests	1	1	1	1	1
Total Cap. & Liab.	**758**	**936**	**1,158**	**1,354**	**1,570**
Non-Cash Wkg. Capital	142	104	72	87	107
Net Cash/(Debt)	139	170	213	246	311
Debtors Turn (avg days)	39.6	40.2	38.8	39.2	39.6
Creditors Turn (avg days)	17.8	22.3	26.2	26.9	27.2
Inventory Turn (avg days)	45.5	47.8	40.4	41.5	41.9
Asset Turnover (x)	1.3	1.2	1.2	1.2	1.2
Current Ratio (x)	4.4	3.4	2.5	2.5	2.7
Quick Ratio (x)	3.2	2.6	1.9	1.9	2.1
Net Debt/Equity (X)	CASH	CASH	CASH	CASH	CASH
Net Debt/Equity ex MI (X)	CASH	CASH	CASH	CASH	CASH
Capex to Debt (%)	244.4	1,537.4	1,521.0	1,521.0	1,521.0
Z-Score (X)	20.2	17.5	13.8	12.8	NA

Asset Breakdown (2014)



RM170m net cash as of Mar-13

Source: Company, DBS Vickers

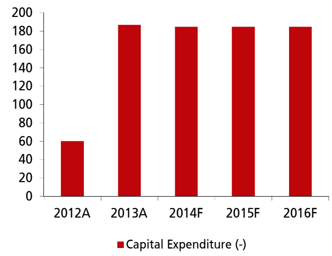
Cash Flow Statement (RM m)

FY Mar	2012A	2013A	2014F	2015F	2016F
Pre-Tax Profit	259	306	340	398	453
Dep. & Amort.	29	37	52	66	81
Tax Paid	(49)	(59)	(14)	(78)	(96)
Assoc. & JV Inc/(loss)	0	0	0	0	0
Chg in Wkg.Cap.	(44)	36	(32)	(33)	(34)
Other Operating CF	7	(2)	0	0	0
Net Operating CF	**201**	**317**	**345**	**354**	**405**
Capital Exp.(net)	(60)	(187)	(185)	(185)	(185)
Other Invts.(net)	0	0	0	0	0
Invts in Assoc. & JV	0	0	0	0	0
Div from Assoc & JV	0	0	0	0	0
Other Investing CF	0	(7)	0	0	0
Net Investing CF	**(60)**	**(194)**	**(185)**	**(185)**	**(185)**
Div Paid	(87)	(99)	(118)	(136)	(155)
Chg in Gross Debt	(15)	(12)	0	0	0
Capital Issues	0	0	0	0	0
Other Financing CF	7	7	0	0	0
Net Financing CF	**(95)**	**(104)**	**(118)**	**(136)**	**(155)**
Currency Adjustments	0	0	0	0	0
Chg in Cash	46	19	43	33	65
Opg CFPS (sen)	35.5	38.7	47.1	48.2	54.7
Free CFPS (sen)	20.4	17.9	20.0	21.1	27.4

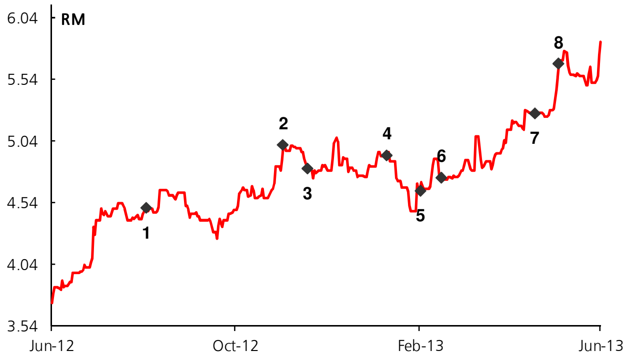
45% dividend payout assumption

Source: Company, DBS Vickers

Capital Expenditure



Target Price & Ratings History



S.No.	Date	Closing Price	Target Price	Rating
1:	08 Aug 12	4.50	4.70	Hold
2:	07 Nov 12	5.01	4.70	Hold
3:	23 Nov 12	4.82	4.70	Hold
4:	15 Jan 13	4.93	4.70	Hold
5:	06 Feb 13	4.64	4.80	Hold
6:	20 Feb 13	4.75	4.80	Hold
7:	23 Apr 13	5.27	5.50	Hold
8:	09 May 13	5.67	5.50	Hold

***Note**: Share price and Target price are adjusted for corporate actions.*

Source: DBS Vickers

DBSV recommendations are based an Absolute Total Return* Rating system, defined as follows:
STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return i.e. > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame)

Share price appreciation + dividends

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