AmResearch

Company report

HARTALEGA HOLDINGS

(HART MK, HTHB.KL) **13 June 2013**

NGC land in hand

HOLD

(Maintained)

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Rationale for report: Company Update

Price	RM6.30
Fair Value	RM6.10
52-week High/Low	RM6.31/RM3.84

Key Changes

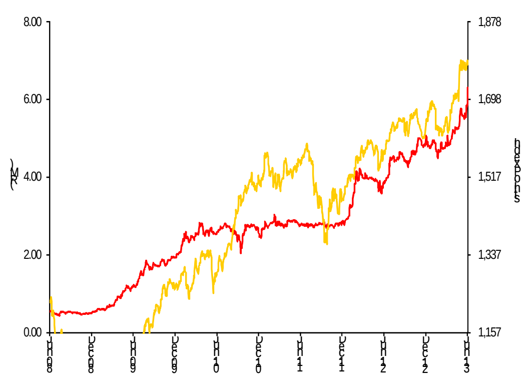
Fair value	↑
EPS	Unchanged

YE to Mar	FY13	FY14F	FY15F	FY16F
Revenue (RMmil)	1,032.0	1,237.6	1,344.7	1,646.5
Core net profit (RMmil)	234.7	268.8	287.0	350.8
FD EPS (Sen)	31.7	33.4	35.7	43.6
EPS growth (%)	16.1	15.0	6.8	22.2
Consensus EPS (Sen)	n/a	n/a	n/a	n/a
DPS (Sen)	14.8	15.0	16.0	21.5
FD PE (x)	19.7	17.1	16.0	13.1
EV/EBITDA (x)	14.5	13.4	11.8	9.8
Div yield (%)	2.3	2.4	2.5	3.4
ROE (%)	33.9	35.1	34.0	34.3
Net Gearing (%)	n/a	18.4	6.6	20.8

Stock and Financial Data

Shares Outstanding (million)	734.0
Market Cap (RMmil)	4,624.1
Book value (RM/share)	0.95
P/BV (x)	6.6
ROE (%)	33.9
Net Gearing (%)	n/a
Major Shareholders	Hartalega Industries Sdn Bhd (50.1%) Budi Tenggara (4.9%)
Free Float (%)	44.8
Avg Daily Value (RMmil)	4.0

Price performance	3mth	6mth	12mth
Absolute (%)	19.0	20.0	51.4
Relative (%)	11.4	10.2	38.7



Investment Highlights

- **We maintain our HOLD recommendation on Hartalega Holdings but raise our fair value of RM6.10/share as we roll forward our valuation base to FY15F and raise our target PE to 17x (previously at 15x) to narrow the discount to industry peer and leader (in volume terms) Top Glove's 19x. Its market capitalisation has also surpassed Top Glove's.**

- **In a filing to Bursa Malaysia yesterday, Hartalega announced that it has entered into an agreement to purchase a 112-acre land (3x its current land size) in Sepang for RM97mil. Based on our checks on land prices in the vicinity, we deem the combined acquisition price of RM19.84/sq ft to be fair.**

- **We gather that the acquisition will be funded by a revolving credit facility. The group's financials remain healthy with FY13 net cash of RM170mil. The estimated FY14F-FY16F capex of RM750mil for the NGC can be internally funded.**

- **This parcel of land had been earmarked for Hartalega's Next Generation Integrated Glove Manufacturing Complex (NGC) since February 2012. Given the 6-month acquisition delay from an end-2012 target, this notice will admittedly allay some doubts over the group's long-term growth plan and improve its earnings visibility.**

- **Recall that NGC is a RM1.9bil, 8-year investment which will see Hartalega's installed capacity grow to 43bil pcs per annum (p.a.) by FY21 (10-year CAGR of 14%). The additional capacity will be contributed by 72 lines from 6 new plants.**

- **We believe this project will enable Hartalega to further reduce its cost per glove (FY13: -9% YoY to 6.9 sen) following:- (1) efficiency gains from greater economies of scale; (2) increased productivity from the automation of its inspection and packaging processes; and (3) opportunities to fine-tune its cost structure.**

- **More importantly, we highlight that earnings will only pick-up in FY16F, when its installed capacity reaches 20 bil pcs p.a. (+30% YoY). The group's FY14F-FY15F net profit growth will be capped by rising costs and its lack of capacity (CY13-14 capacity growth of 2% vs. peers' 3% average) which will hamper its ability to further exploit the current robust glove demand (FY14F: +8% to +10%).**

- **Hartalega's share price has rallied 33% YTD. We attribute this to:- (1) investors re-rating the group based on their past experience with Top Glove; (2) emergence of various health threats; and (3) the sharp recovery of the USD against the RM (+6% in the last month to reverse the earlier 5% decline).**

- **No change to our FY14F-FY16F earnings and gross DPS forecasts. We have already incorporated the lower contribution from NGC into our earnings model. Post the sharp rise in its share price, Hartalega's FY14F-FY16F average dividend yields of 2.8% are decent, but not attractive.**

PP 12247/06/2013 (032380)

MAINTAIN HOLD, RAISE FAIR VALUE

We maintain our HOLD recommendation on Hartalega Holdings but raise our fair value of RM6.10/share as we roll forward our valuation base to FY15F and raise our target PE to 17x (from 15x, previously), which is 2SD above its 3-year mean PE of 12x.

Our higher PE target reflects a narrower discount to industry peer and leader (in volume terms) Top Glove's fair PE of 19x. We note that Hartalega's market capitalisation has surpassed Top Glove's.

S&P SIGNED, FINALLY

In a filing to Bursa Malaysia yesterday, Hartalega announced that it has entered into an agreement to purchase a 112-acre land (3x its current land size in Bestari Jaya) in Mukim Labu, Sepang for RM97mil. This amount excludes the additional land-filling and road access costs needed to bring it to a usable condition.

The land is located close to the Kuala Lumpur International Airport and the manufacturing facilities of one of its competitors. It consists of 3 plots - a 95 acre industrial land, a 17 acre agricultural land as well as a smaller 7,000 sq ft piece.

- ***Price paid seems fair, funded by bank borrowings***

We deem the acquisition price for the 3 parcels collectively (RM19.80/sq ft) to be fair. Our checks reveal that industrial land in the area costs between RM18-25/sq ft while agricultural land ranges between RM4-RM7/sq ft.

We gather that the acquisition will be funded by a revolving credit facility. The group's financials remain healthy with FY13 net cash at RM170mil. The estimated FY14F-FY16F capex of RM750mil (including land cost) can be internally funded.

- ***Land had been earmarked for NGC project***

We understand that this parcel of land had been identified as the site of Hartalega's Next Generation Integrated Glove Manufacturing Complex (NGC) back in February 2012.

Following the unveiling of the NGC project in March 2012, management had in later discussions guided for the land deal to be finalised by end-2012. Construction was initially scheduled to commence in 1HCY13 with commissioning beginning in January 2014.

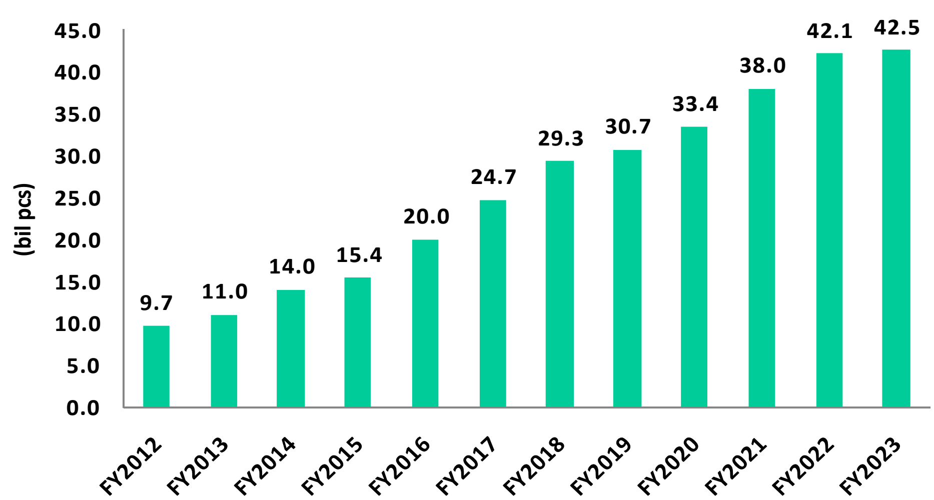
However, due to delays in obtaining certain approvals, the signing of the agreement has been pushed back by 6 months. With the acquisition expected to be fully completed within the next 3 months, management is confident it will be able to adhere to its latest timeframe guidance ie, breaking ground in Sept 2013 with commissioning of its first line in August 2014.

- ***Some certainty, but further delays not surprising***

Although this announcement had long been anticipated, this development admittedly allays some doubts over Hartalega's long term growth plans and improves its earnings visibility.

Nonetheless, we do caution that further delays may be inevitable given the tight schedule. Management said that it is open to building concurrently instead of progressively should the need arises. This will also depend on the future global demand for rubber gloves (FY14F: +8% to +10%)

CHART 1 : CAPACITY PROJECTION WITH NGC CONTRIBUTION FROM FY15F



Source: Company, AmResearch

WHAT IS NGC?

❑ ***Hartalega's next growth phase, 10-year capacity CAGR of 14%***

Hartalega's NGC is a RM1.9bil, 8-year investment which will see its installed capacity grow to 43bil pcs per annum (p.a.) by FY21 (FY14F: 14bil pcs). The additional capacity will be contributed by 72 lines from 6 new plants (10-year production capacity CAGR of 14%).

This project, which has been accorded the EPP ("Entry Point Project") status under the Malaysian Government's Economic Transformation Programme, is key to maintaining its leadership in the nitrile gloves segment.

At present, the group commands 19% of the global nitrile glove market and 7% of the world glove market.

Management has apportioned 80%-90% of the installed capacity for the production of nitrile gloves while the other 10%-20% will be for natural rubber and specialty gloves.

❑ ***More than a manufacturing hub***

In addition to the new production lines, the group intends to construct other integrated glove manufacturing facilities, including:

- R&D Centre ("Centre of Excellence")
- Renewable Energy Complex
- Training and Development Centre
- Sports and Recreational Complex
- Eco-friendly Workers Quarters

❑ ***Construction split to two 4-year phases***

The first phase (2013-2017) will see the addition of 42 production lines with total annual capacity of 16.5 bil pcs while the second phase (2018-2021) will lift annual capacity by 12 bil pcs with another 30 production lines.

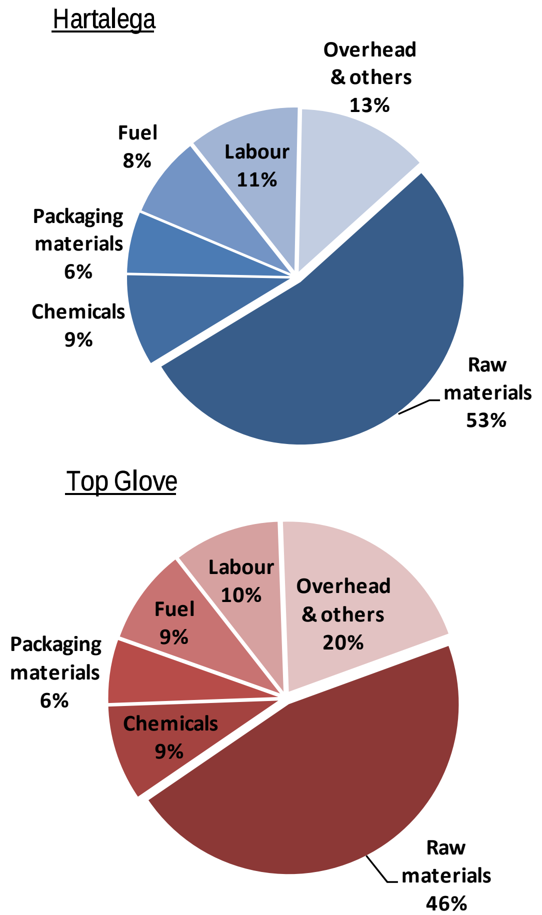
TACKLING COST INFLATIONS HEAD-ON

❑ ***Efficiency gains from economies of scale***

We believe this project will enable Hartalega to further reduce its cost per glove (FY13: -9% to 6.9 sen) following efficiency gains from economies of scale.

Being the largest nitrile glove producer, we reckon that Hartalega can already procure its nitrile inputs at a more favourable price than its peers. As of May 2013, nitrile prices stand at USD1,135/metric tonne.

CHART 2: PRODUCTION COSTS BREAKDOWN



Source: Companies, AmResearch

❑ ***Engineering expertise to raise productivity, offset wage hikes***

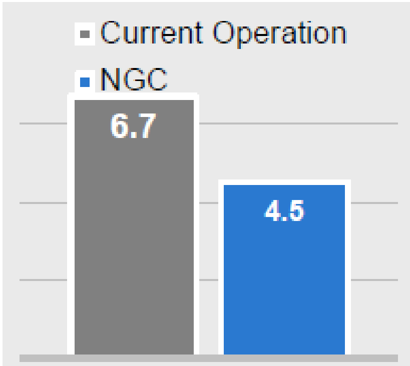
Hartalega can also leverage on its in-house engineering capabilities to increase productivity. As it is, the group is working on two more automation projects, namely in inspection (quality control) and packaging.

Together with glove stacking, packaging is the most labour-intensive part of production. The group is already known as the most technologically advanced rubber glove manufacturer.

The highly automated production processes are aimed at reducing manual labour and more specifically, reliance on foreign workers (-76%) in its plants. Staff cost, as a percentage of revenue, is expected to gradually reduce by about 1/3 to 4.5%. Annual savings are estimated at RM52mil.

In line with that, output per employee is expected to grow by 62% over the period to 4.7 mil pcs/worker/year.

CHART 3: STAFF COSTS AS A % OF SALES



Source: Company / AmResearch

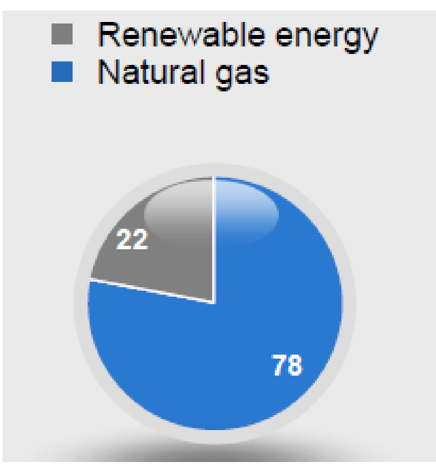
Countering rising energy costs

Energy costs constitute ~9% of Hartalega's total production costs. Natural gas makes up the bulk (90%) of its energy needs with the remainder derived from biomass. In comparison, Top Glove only sources 55% of its energy needs from natural gas, while biomass (35%) and coal (10%) are its other sources.

The current threat of gas price hikes from a subsidy rollback brings with it some urgency to reduce its reliance on natural gas. As such, Hartalega will take this opportunity to expand its biomass energy source to 22%.

The downsides to this renewable energy include:- (1) the inconsistent heat levels, which may impact the line's productivity as well as quality of gloves; and (2) the large space needed to store the inventory (eg. palm kernel and empty fruit bunches).

CHART 4: ENERGY SOURCES WITH NGC



Source: Company / AmResearch

EARNINGS IMPACT ONLY FROM FY16F

Slower earnings in FY14F-FY15F

While the group's FY14F net profit (+15% YoY) will be supported by new capacity from its fully commissioned Plant 6 (by July 2013), the 8-month setback in constructing and commissioning Plant 7 in Sepang (~220mil pcs) will result in a revenue decline of ~2% in FY15F.

Coupled with higher production costs from:-

(1) a burgeoning workforce (+1200 workers since January 2012);

(2) possible recovery in nitrile prices in tandem with a recovering automotive sector in 2014 (on average, +7% YoY across the main segments); and

(3) to a lesser extent, greater fuel costs,

FY15F earnings growth is forecasted to be much slower at +7%. This excludes a possible slowdown in overall glove demand and greater falls in ASPs should a full price war break out.

Note that in FY13, staff costs rose 1.2ppts to 7.3% after years of decline, resulting in labour's portion of total production costs growing from 9% to 12% over the four quarters. This was mainly due to the company employing ahead of its NGC rollout, and less the consequence of a minimum wage policy. We expect this cost to remain inflated until the first plant is up and running.

Handicapped in the near-term

Hartalega's lack of capacity (CY13-14 capacity growth of 2% vs peers' 3% average) and oversold position in the immediate term places it at a disadvantage to its peers as it will be unable to flex its muscle as the leader in the nitrile segment (coincidently, the key growth segment for rubber gloves overall) to further exploit the current healthy growth in global glove consumption.

Earnings to pick-up in FY16F

Come FY16F, Hartalega's earnings is anticipated to jump by 22% as new capacities come onstream (YoY: +30% to 20bil pcs). Greater efficiency at its plants will help trim its production costs too.

SHARE PRICE MOMENTUM CARRYING THROUGH

Despite Hartalega's stellar performance in 2012 (+63%), its share price has continued to rally 33% YTD, outperforming the FBM KLCI by 28ppts. The YTD run-up mimics that of its peers, with Top Glove climbing 14% and Kossan gaining 32%.

We attribute this strong performance to:-

(1) investors re-rating the group based on their past experience with Top Glove. Recall Top Glove's

rapid and aggressive capacity expansion in the past decade (CAGR of 24%) saw its PE multiple expand from 6x in 2002 to its peak of 30x in 2012;

(2) emergence of various health threats, namely H7N9 bird flu in April 2013 and Middle East Respiratory Syndrome Coronavirus (MERS-CoV) in May 2013 which is expected to spur demand for rubber gloves worldwide;

(3) the entrance of a new pool of investors given Hartalega's improved liquidity and market capitalisation; and

(4) the strengthening of the USD against the RM. The 6% gain in the past month had more than outstripped the 5% fall in the March to May 2013 period. This is beneficial for exporters like the rubber glove players.

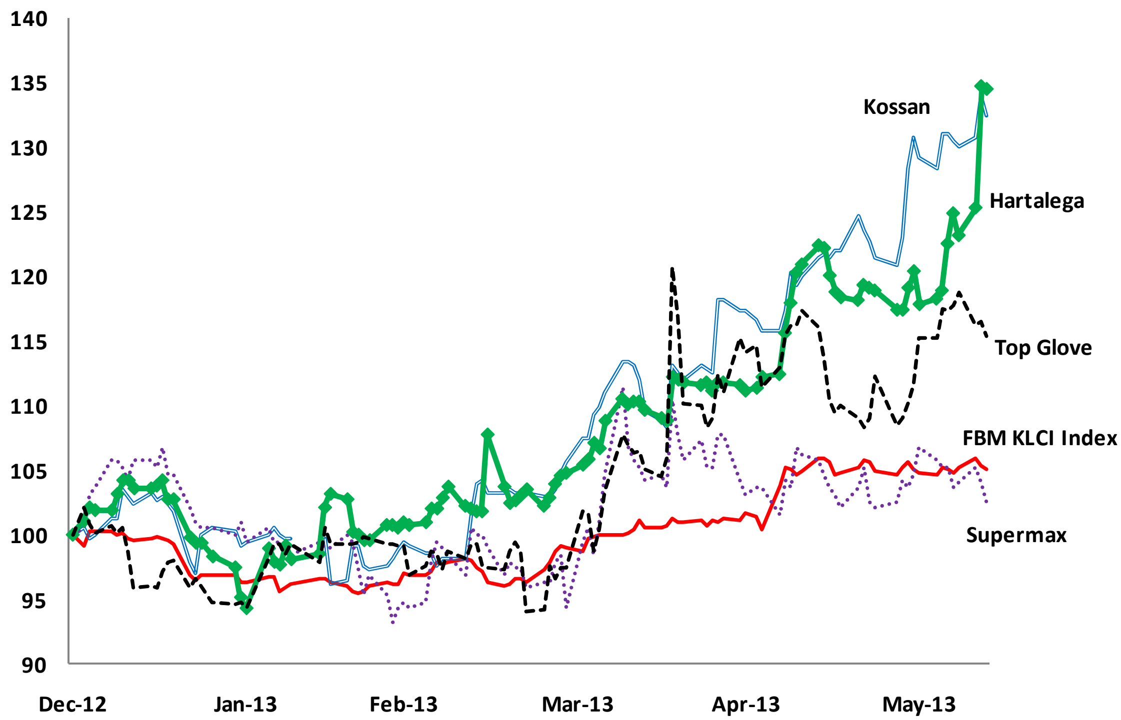
At RM6.30/share, the stock is currently trading at 19x its fully-diluted FY14F EPS and 18x its fully-diluted FY15F EPS.

EARNINGS FORECASTS MAINTAINED

No change to our FY14F-FY16F earnings and gross DPS forecasts. In an earlier report dated May 3 2013, we had already adjusted our earnings model to account for the delays.

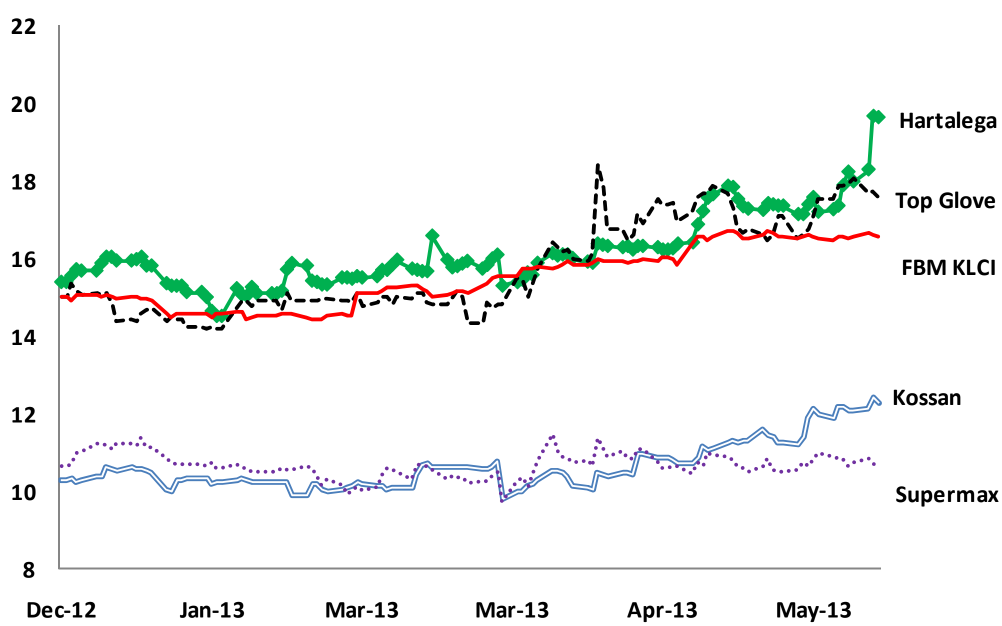
Post the sharp rise in its share price, Hartalega's FY14F-FY16F average dividend yields of 2.8% (payout ratio: 45%) are decent, but not attractive.

CHART 5: RELATIVE PRICE PERFORMANCE



Source: Company / AmResearch

CHART 6: RELATIVE PE RATIOS (X)



Source: Company / AmResearch

CHART 7: AERIAL VIEW OF NGC

Source: Company / AmResearch

CHART 8: NGC PROJECT LAYOUT

Source: Company / AmResearch

CHART 9: PB BAND CHART

CHART 10: PE BAND CHART

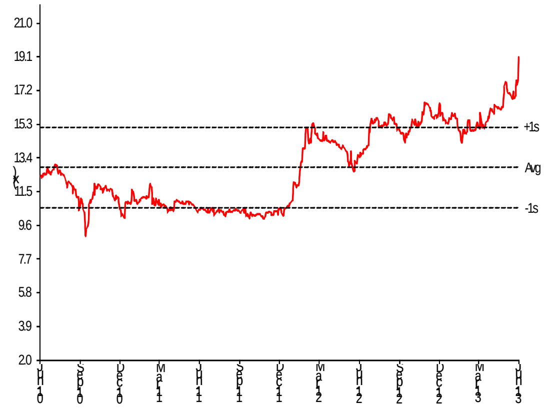


TABLE 1 : FINANCIAL DATA

Income Statement (RMmil, YE 31 Mar)	2012	2013	2014F	2015F	2016F
Revenue	931.1	1,032.0	1,237.6	1,344.7	1,646.5
EBITDA	288.2	337.9	392.0	437.4	546.0
Depreciation	(29.0)	(31.9)	(43.2)	(59.8)	(75.0)
Operating income (EBIT)	259.2	305.9	348.8	378	470.9
Other income & associates	0.0	0.0	0.0	0.0	0.0
Net interest	(0.8)	(0.1)	(6.0)	(11.5)	(17.9)
Exceptional items	0.0	0.0	0.0	0.0	0.0
Pretax profit	258.4	305.9	342.8	366.0	453.1
Taxation	(57.0)	(70.8)	(73.7)	(78.7)	(101.9)
Minorities/pref dividends	(0.1)	(0.3)	(0.3)	(0.3)	(0.3)
Net profit	201.4	234.7	268.8	287.0	350.8
Core net profit	201.4	234.7	268.8	287.0	350.8

Balance Sheet (RMmil, YE 31 Mar)	2012	2013	2014F	2015F	2016F
Fixed assets	370.3	485.8	670.6	839.6	1,044.3
Intangible assets	0.0	6.9	0.0	0.0	0.0
Other long-term assets	9.9	49.8	49.6	49.6	49.6
Total non-current assets	380.2	542.5	720.3	889.2	1,093.9
Cash & equivalent	163.2	182.4	55.6	282.5	173.4
Stock	97.5	86.6	145.1	93.6	195.9
Trade debtors	107.7	119.9	178.4	145.8	251.2
Other current assets	9.5	4.8	9.5	9.5	9.5
Total current assets	377.9	393.8	388.6	531.4	630.0
Trade creditors	29.5	56.2	28.1	62.3	47.4
Short-term borrowings	12.6	7.7	84.3	128.2	172.4
Other current liabilities	43.4	51.2	42.7	42.7	42.7
Total current liabilities	85.5	115.0	155.1	233.2	262.5
Long-term borrowings	12.1	4.5	144.3	219.5	296.2
Other long-term liabilities	40.5	50.3	43.4	43.7	42.9
Total long-term liabilities	52.6	54.8	187.7	263.1	339.2
Shareholders' funds	619.5	765.5	765.5	923.8	1,121.7
Minority interests	0.6	1.0	0.6	0.6	0.6
BV/share (RM)	0.77	0.95	0.95	1.15	1.39

Cash Flow (RMmil, YE 31 Mar)	2012	2013	2014F	2015F	2016F
Pretax profit	258.4	305.9	342.8	366.0	453.1
Depreciation	29.0	31.9	43.2	59.8	75.0
Net change in working capital	(44.5)	35.7	(145.0)	118.4	(222.7)
Others	(42.6)	(56.3)	(73.7)	(78.7)	(101.9)
Cash flow from operations	200.3	317.2	167.3	465.5	203.5
Capital expenditure	(35.4)	(18.2)	(300.0)	(200.0)	(250.0)
Net investments & sale of fixed assets	0.1	0.0	0.1	0.1	0.1
Others	(24.8)	(175.9)	(30.0)	(30.0)	(30.0)
Cash flow from investing	(60.1)	(194.0)	(329.9)	(229.9)	(279.9)
Debt raised/(repaid)	(14.6)	(12.5)	114.0	119.0	119.0
Equity raised/(repaid)	0.0	0.0	0.0	0.0	0.0
Dividends paid	(87.4)	(98.8)	(114.9)	(128.8)	(152.9)
Others	6.9	7.3	0.0	0.0	0.0
Cash flow from financing	(95.0)	(104.0)	(0.9)	(9.8)	(33.9)
Net cash flow	45.2	19.2	(163.5)	225.9	(110.2)
Net cash/(debt) b/f	59.7	31.7	(277.5)	106.9	(229.2)
Net cash/(debt) c/f	138.6	170.2	(173.1)	(65.1)	(295.3)

Key Ratios (YE 31 Mar)	2012	2013	2014F	2015F	2016F
Revenue growth (%)	26.7	10.8	19.9	8.7	22.4
EBITDA growth (%)	7.5	17.2	16.0	11.6	24.8
Pretax margins (%)	27.8	29.6	27.7	27.2	27.5
Net profit margins (%)	21.6	22.7	21.7	21.3	21.3
Interest cover (x)	149.3	338.8	58.0	26.2	23.1
Effective tax rate (%)	22.0	23.2	21.5	21.5	22.5
Net dividend payout (%)	45.3	46.8	44.9	44.9	49.3
Debtors turnover (days)	40	40	44	44	44
Stock turnover (days)	32	33	34	32	32
Creditors turnover (days)	13	15	12	12	12

Source: Company, AmResearch estimates

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