

3 May 2012

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Stocks under coverage

Company	Bloomberg Ticker	Call	TP (RM)
Hartalega	HART MK	Buy	9.40
Top Glove	TOPG MK	Neutral	4.73
Supermax	SUCB MK	Neutral	1.91
Kossan	KRI MK	Buy	4.70

Rubber Glove

Sector Update

Neutral ↑

Not sweating over minimum wage policy

Prime Minister Dato' Sri Najib Razak unveiled the minimum wage for the private sector with a floor of RM900 per month for Peninsular Malaysia and RM800 per month for East Malaysia on 30 April 2012. Despite its negative impact on the glove industry, we expect glove makers to be able to mitigate most of the impact via (1) cost pass through, (2) restructuring existing employees' compensation package, and/or (3) speed up the automation process to reduce the need for unskilled labour. Hence, we keep our forecasts unchanged for glove makers under coverage until we are able to gauge the actual impact from 2013 onwards. While our underweight call on the sector has been proven right, valuations are more reasonable now while external headwinds such as high latex cost and weak USD are dissipating. As such, we upgrade the sector to **NEUTRAL**.

Set minimum wage at RM800-900 per month

- On 30 April, the PM unveiled the minimum wage for the private sector with a floor of RM900 per month for Peninsular Malaysia and RM800 per month for East Malaysia, which will be effective 6 months from the date the minimum wage order (MWO) is gazetted, except for micro enterprises which will have a 12-month grace period.
- On the positive front, the minimum wage of RM800-900 could include fixed cash payments or allowances to the employees. Furthermore, any employers who fail to comply within the grace period could also apply for extension of the transition period, according to the PM. The policy will be reviewed once every two years.

CY13 earnings erosion of 3-11% could be largely mitigated

- Based on our analysis, the direct impact on glove makers is considerably significant, ranging from 3% to 11% of CY13 earnings. Top Glove is the most affected glove maker with 11% erosion to its CY13 earnings, while Hartalega seems to be the least affected with 3% earnings erosion. Kossan and Supermax's CY13 earnings might be reduced by 9% and 7% respectively.
- However, we believe most of the glove makers could mitigate the impact via (1) cost pass through to customers given that the whole industry is affected, (2) restructuring existing employee's compensation package e.g. paying more fixed allowances instead of variable compensation such as overtime and performance-based allowances, and/or (3) speed up the automation process to reduce the need for unskilled labour.

Maintain forecasts for all glove makers

- Given potential mitigating factors, we keep our forecasts unchanged until we can gauge the actual impact from the implementation of minimum wage starting from 2013, which could also be delayed if glove makers apply for extension of the transition period.

Upgrade to NEUTRAL on dissipating headwinds

- We have been proven right with our underweight call on the glove sector which has underperformed the FBMKLCI by 9.8% since our initiation on 8 Feb 2012.
- However, given external headwinds such as high latex cost and weak USD are dissipating, we upgrade the sector to **NEUTRAL** now.
- We like **Hartalega** and **Kossan** with **BUY** recommendations and TP of RM9.40 and RM4.70 respectively, based on 15x and 13x of their 12-month forward earnings respectively. We see Hartalega as a game-changer in the glove industry, thanks to its newly announced NGC project, which could increase its capacity by an 8-year CAGR of 15.7%! While Kossan appears to be the most balanced glove makers (NR glove 56:44 nitrile glove) which gives it the most flexibility to react quickly to changes in demand.
- On the other hand, we retain our Neutral recommendations for both **Top Glove** (TP: RM4.73) and **Supermax** (TP: RM1.91), as we believe both of the companies are fair at its 5-year historical mean valuation now, without an industry up or down cycle.



SNAPSHOT OF FINANCIAL AND VALUATION METRICS

Figure 1 : Peer comparison

Company	Call	Target price (RM)	Share price (RM)	Mkt Cap (RM m)	EPS Growth (%)		P/E (x)		P/BV (x)		ROE (%)		Net Dividend Yield (%)	
					CY12	CY13	CY12	CY13	CY12	CY13	CY12	CY13	CY12	CY13
Hartalega	Buy	9.40	7.80	2,849.9	11.8	14.7	12.8	11.2	4.1	3.4	31.6	30.2	3.5	4.0
Top Glove	Neutral	4.73	4.56	2,821.0	42.1	6.2	16.6	15.6	2.3	2.1	13.6	13.8	2.8	3.9
Supermax	Neutral	1.91	1.87	1,271.9	9.8	13.0	10.1	8.9	1.5	1.3	14.7	14.9	3.0	3.4
Kossan	Buy	4.70	3.24	1,035.9	22.8	21.1	9.2	7.6	1.7	1.5	18.7	19.3	2.5	3.1
Latexx	N/R	N/R	1.41	314.2	21.2	16.7	5.9	5.0	N/A	N/A	16.7	17.3	3.4	4.0
Adventa	N/R	N/R	1.39	212.4	565.4	36.4	9.6	7.1	1.0	N/A	9.3	11.3	5.4	N/A
Average					23.4	14.1	12.1	10.6	2.1	2.1	20.2	19.9	3.0	3.7

Source: Alliance Research, Bloomberg

Share price date: 2 May 2012

Figure 2 : Share price performance

Company	Share price RM	Month-to-date %	Year-to-date %	30-day %	90-day %	180-day %	365-day %
Hartalega	7.80	0.00	33.56	-1.89	2.23	42.60	36.84
Top Glove	4.56	-2.77	-8.80	1.33	-9.88	7.04	-12.14
Supermax	1.87	-1.06	-2.35	-1.58	-12.62	-0.27	-9.44
Kossan	3.24	-0.31	-0.31	-1.52	-8.73	13.68	0.31
Latexx	1.41	0.00	-26.18	-1.40	-28.06	-22.53	-48.54
Adventa	1.39	-2.80	-12.58	-9.74	-17.75	-18.24	-38.22
FBMKLCI Index	1,582.39	0.75	3.37	-0.87	4.02	7.23	3.09

Source: Bloomberg

NOT SWEATING OVER MINIMUM WAGE POLICY...

Introducing minimum wage policy in Malaysia

Minimum wage set at RM800-900 per month

On 30 April 2012, Prime Minister (PM) Dato' Sri Najib Razak unveiled the minimum wage for the private sector with a floor of RM900 per month for Peninsular Malaysia (RM4.33 per hour) and RM800 per month for East Malaysia (RM3.85 per hour). According to the PM, the minimum wage would cover workers in all sectors (including foreign workers) except for domestic help service or maid, gardener and similar employment categories. The minimum wage will take effect 6 months from the date the minimum wage order (MWO) is gazetted, except for micro enterprises which will have a longer grace period of 12-month to implement the policy. However, there is no exception for professional firms such as health clinics, law, architecture and consulting firms, even if these firms employ less than 5 workers.

Fortunately, it includes fixed allowances

On the positive front, the minimum wage of RM800-900 could include fixed cash payments or allowances to employees, which to some extent, reduces the burden of employers who are already compensating employees with overall take-home pay above the minimum wage. Furthermore, employers who fail to implement the minimum wage within the grace period could also apply for extension of the transition period, according to the PM. The policy will be reviewed once every two years.

Impact on the glove makers

Direct impact is considerably significant, ranging from 3-11% of CY13 earnings, however, we believe most of the impact could be mitigated...

Based on our analysis, the direct impact on glove makers is considerably significant, ranging from 3% to 11% of CY13 earnings. However, we believe most of the glove makers could mitigate the impact via (1) cost pass through to customers given that the whole industry is affected, (2) restructuring existing employee's compensation package e.g. paying more fixed allowances instead of variable compensation such as overtime and performance-based allowances, and/or (3) speed up the automation process to reduce the need for unskilled labour. Hence, we keep our forecasts unchanged until we can gauge the actual impact from the implementation of minimum wage starting from 2013, which could also be delayed if glove makers apply for extension of the transition period.

Figure 3 : Comparison of minimum wage impact on glove makers

Impact of minimum wage policy of > RM900 on glove makers	Top Glove	Hartalega	Supermax	Kossan	Sum/ average
# of employees with					
(i) basic salary & fixed allowance of < RM900 (a)	6,860	2,508	3,270	4,150	16,788
(ii) basic salary & fixed allowances of > RM900	4,040	580	230	850	5,700
Total	10,900	3,088	3,500	5,000	22,488
% of workers					
(i) basic salary & fixed allowance of < RM900	62.9%	81.2%	93.4%	83.0%	74.7%
(ii) basic salary & fixed allowances of > RM900	37.1%	18.8%	6.6%	17.0%	25.3%
RM					
Average monthly basic salary	590	541	550	550	558
Average monthly fixed allowances	60	80	100	100	85
Total avg monthly wage *	650	621	650	650	643
Minimum wage set by government	900	900	900	900	900
Required monthly salary adjustment (b)	250	279	250	250	257
RM m					
Annualised direct labour costs based on latest reported number	166	72	48	115	401
Avg total gross monthly wage per employee (RM)	1,269	1,932	1,143	1,917	1,484
Estimated net profit for CY13	181	253	142	137	713
Estimated CY13 net profit per employee (RM k)	16.6	81.9	40.7	27.3	31.7
Impact of minimum wage of RM900					
Additional cost p.a (RM m) ($c = a \times b \times 12 / 1000000$)	20.6	8.4	9.8	12.5	51.8
% of direct labour cost	12.4%	11.7%	20.4%	10.8%	12.9%
% of net profit in CY13	11.4%	3.3%	6.9%	9.1%	7.3%

* Supermax and Kossan's average monthly wage is based on Alliance's estimates.

Source: Companies' data, Alliance Research

Top Glove is the most affected glove maker with 11% earnings erosion in CY13

While Hartalega is the least affected with only 3% earnings erosion in CY13, followed by Supermax (7%) and Kossan (9%)

Hartalega appears to have an edge over its peers as it does not need to adjust its ASP as much as its peers to pass on higher labour costs

Nitrile glove still commands cost advantage over NR glove

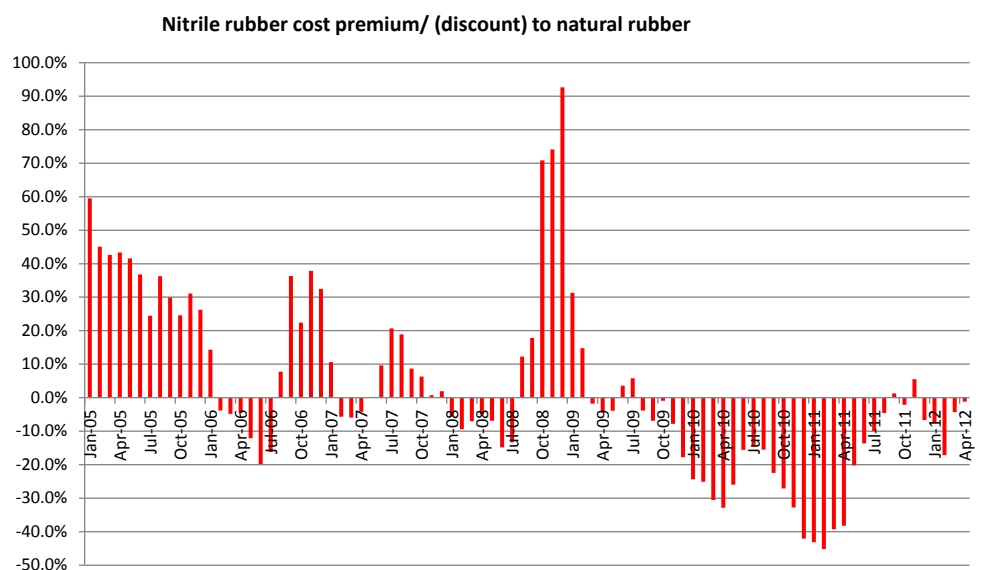
On a relative basis, Top Glove is the most affected glove maker given its large workforce of 10,900 employees. According to the management, there are approximately 6,800 workers or 63% of its workforce earning less than RM900 per month, including fixed allowances. The larger workforce as compared to its peers as well as its business model of focussing on low margin products mean that productivity in terms of net profit per employee is the lowest among peers at just RM16.6k per employee. As such, we estimate the incremental staff cost due to minimum wage implementation is about RM20.6m, or 11.4% of its CY13 earnings.

While the least affected glove maker is Hartalega which has a low workforce of 3,088 employees due to high level of automation. It would only see its CY13 bottom line be eroded by 3.3%, assuming no cost pass through and no salary adjustment for the employees who are not covered by the minimum wage (though this is unlikely if the rest of the employees get a salary adjustment). Based on the same assumptions, Kossan and Supermax's CY13 earnings would also be affected by 9.1% and 6.9% respectively.

In conclusion, the least affected glove maker, Hartalega, may not need to adjust its ASP as much as its peers to pass on the higher labour costs and therefore will have an edge over its peers. As such, we maintain our Buy recommendation for Hartalega and a TP of RM9.40, based on 15x 12-month forward earnings. Again, we would like to stress that the company is due for a rerating over the next 12 months, as its recently announced NGC project which could increase its capacity by an 8-year CAGR of 15.7% is expected to be a game-changer in the glove industry! (Please refer to our report on 16 April 2012 for details.)

We acknowledge that latex price has been coming off recently, from its recent high of RM7.90 per kg to about RM7.40 per kg due to the end of wintering season for the rubber tapping industry. However, we have also seen butadiene price coming off from as high as US\$3,925 per tonne to US\$2,500 per tonne as at 27 April 2012. Based on our analysis, the latex cost for natural rubber (NR) glove and nitrile glove is almost on par in April 2012, with the latter enjoying 1.2% discount to the former, without taking into account the lower rubber consumption by nitrile glove (average- 3.5gram) as compared to natural rubber glove (average 4.5 gram). In other words, nitrile glove is still enjoying significant cost advantage over NR glove, thanks to its 22% less rubber consumption. This keeps the cost competitiveness at nitrile glove segment, although the natural rubber price came off by about 5.1% in April 2012.

Figure 4 : Nitrile butadiene rubber cost vs natural rubber cost



**Adjusted for latex content for nitrile butadiene rubber (45%) and natural rubber (60%).*

Source: Bloomberg data, Alliance Research

We continue to like Kossan given its Blue Ocean Strategy by venturing into the high-end glove segment such as cleanroom glove and surgical glove

Remain Neutral on Top Glove and Supermax

Upgrade glove sector from underperform to NEUTRAL on better valuations now and dissipating headwinds

We also like Kossan given its Blue Ocean Strategy by venturing into the high-end glove segment such as cleanroom glove and surgical glove which is expected to improve its absolute profit per glove over the next 2 years. To recap, Kossan has the most balanced product portfolio as compared to its peers with a sales mix of 56:44 between NR glove and nitrile glove. In addition, up to 90% of its manufacturing capacities are inter-switchable lines which gives the company high flexibility to react quickly to changes in demand for both products. As such, we retain our Buy recommendation on Kossan with a TP of RM4.70, based on 13x 12-month forward earnings.

On the other hand, we are less bullish on Top Glove and Supermax given lack of re-rating catalysts and unexciting albeit fair valuations now at their 5-year mean P/E. As such, we remain neutral on Top Glove and Supermax with unchanged TP of RM4.73 and RM1.91, based on 17x and 10x 12-month forward earnings respectively.

Upgrade the sector from UNDERWEIGHT to NEUTRAL

We have been proven right with our UNDERWEIGHT call on the glove sector which has underperformed the FBMKLCI by 9.8% since our initiation on 8 Feb 2012. However, given external headwinds such as high latex cost and weak USD are dissipating, we upgrade the sector to NEUTRAL now. In addition, the valuation of the glove makers seem to be more reasonable now as most of them have been reverted back to their 5-year historical mean valuation respectively, except for Hartalega and Kossan which have a structural change in their fundamentals and deserve a higher valuation as compared to their historical average, in our view. Furthermore, we have also seen improved discipline in capacity expansion among the glove makers e.g. Top Glove delays its expansion slightly given the slower take up rate on its new capacity. In conclusion, we continue to like Kossan and Hartalega, with the former being our top pick for the sector given its higher upside potential from our TP (+44%).

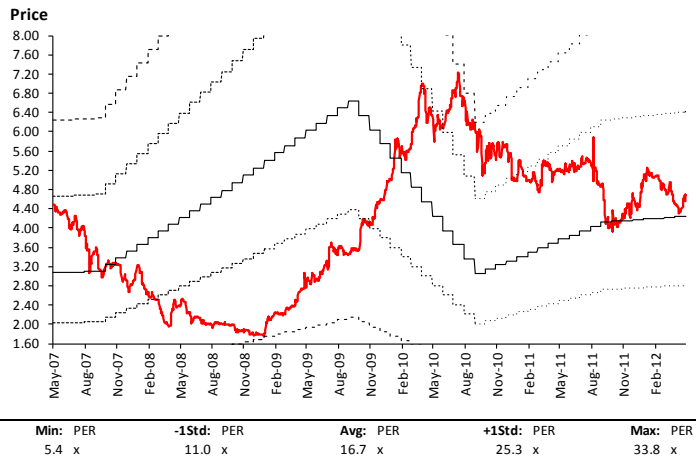
Figure 5 : Companies' share price performances vs FBM KLCI since our initiation

Company or Index	Share price as at		Change %
	8-Feb-12	2-May-12	
Top Glove	5.10	4.58	-10.2%
Supermax	2.09	1.89	-9.6%
Hartalega	8.30	7.77	-6.4%
Kossan	3.57	3.24	-9.2%
<i>Average</i>			<i>-8.8%</i>
FBM KLCI	1,562.8	1,578.4	1.0%

Source: Bloomberg data

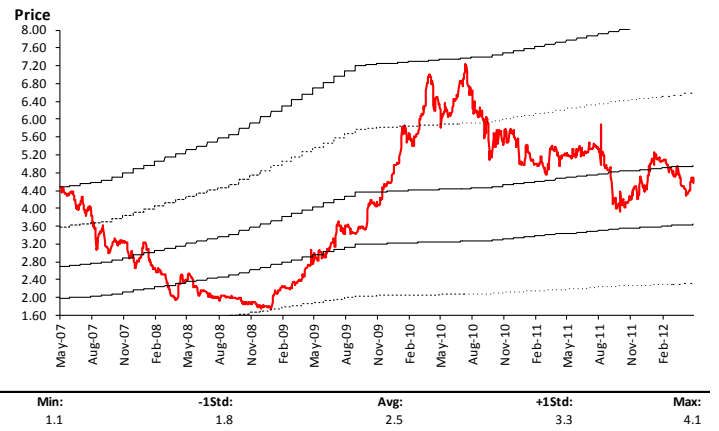
5-year historical valuation bands

Figure 6 : Top Glove P/E Band



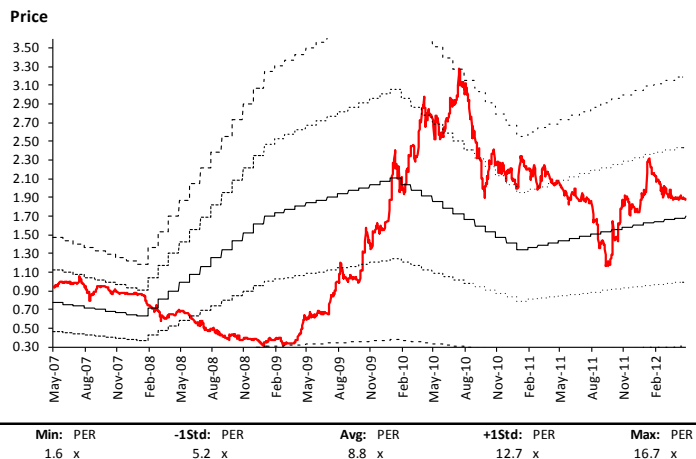
Source: Bloomberg data, Alliance Research

Figure 7 : Top Glove P/B Band



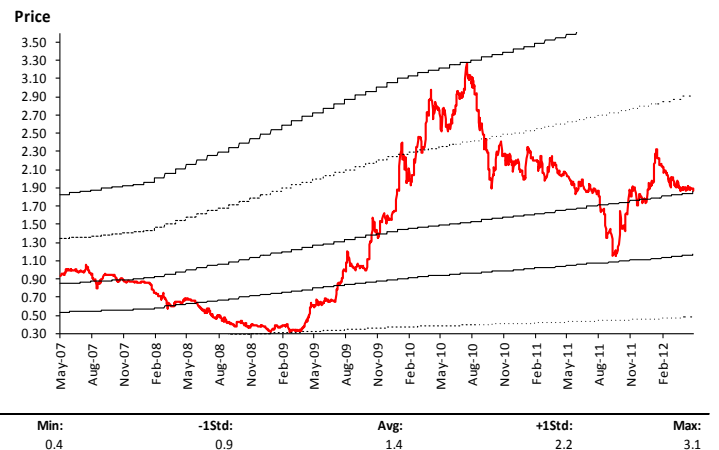
Source: Bloomberg data, Alliance Research

Figure 8 : Supermax P/E Band



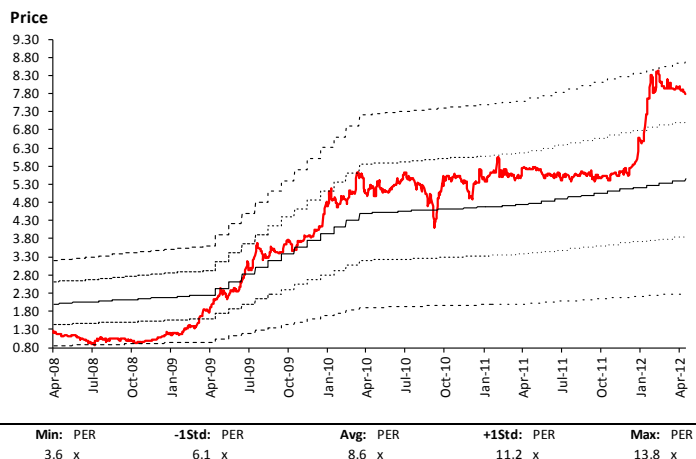
Source: Bloomberg data, Alliance Research

Figure 9 : Supermax P/B Band



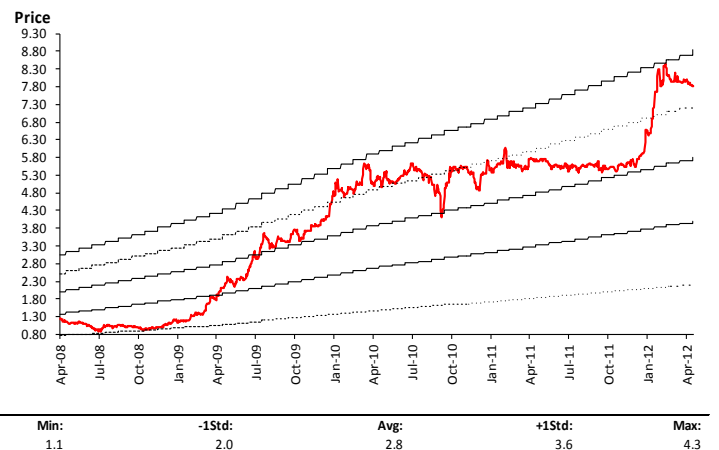
Source: Bloomberg data, Alliance Research

Figure 10 : Hartalega P/E Band



Source: Bloomberg data, Alliance Research

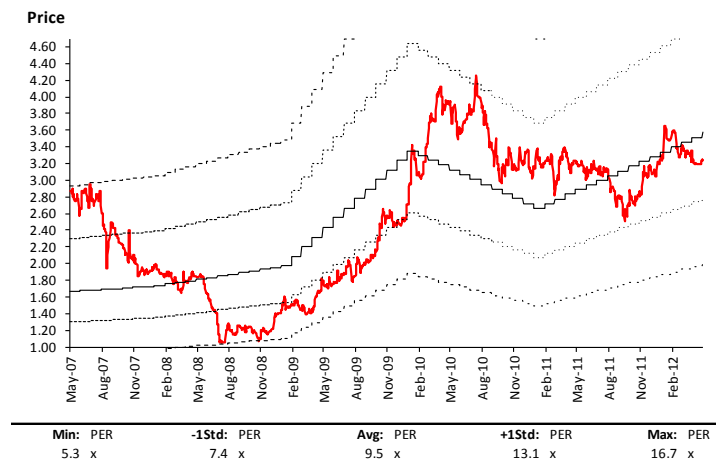
Figure 11 : Hartalega P/B Band



Source: Bloomberg data, Alliance Research

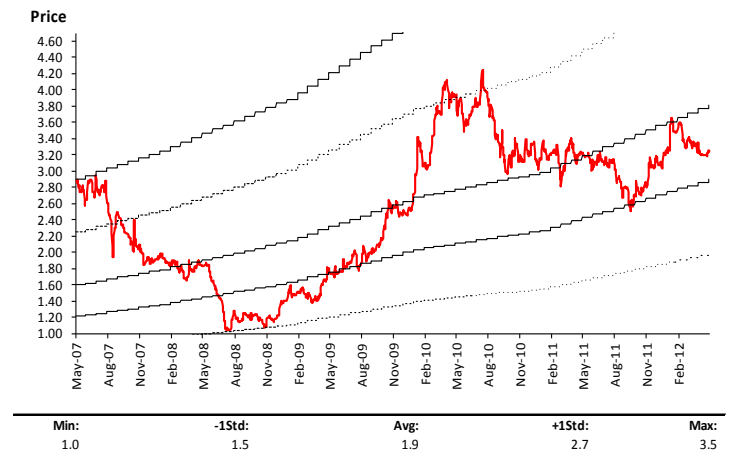


Figure 12 : Kossan Rubber Industries P/E Band



Source: Bloomberg data, Alliance Research

Figure 13 : Kossan Rubber Industries P/B Band



Source: Bloomberg data, Alliance Research

DISCLOSURE

Stock rating definitions

- Strong buy - High conviction buy with expected 12-month total return (including dividends) of 30% or more
- Buy - Expected 12-month total return of 15% or more
- Neutral - Expected 12-month total return between -15% and 15%
- Sell - Expected 12-month total return of -15% or less
- Trading buy - Expected 3-month total return of 15% or more arising from positive newsflow. However, upside may not be sustainable

Sector rating definitions

- Overweight - Industry expected to outperform the market over the next 12 months
- Neutral - Industry expected to perform in-line with the market over the next 12 months
- Underweight - Industry expected to underperform the market over the next 12 months

Commonly used abbreviations

Adex = advertising expenditure	EPS = earnings per share	PBT = profit before tax
bn = billion	EV = enterprise value	P/B = price / book ratio
BV = book value	FCF = free cash flow	P/E = price / earnings ratio
CF = cash flow	FV = fair value	PEG = P/E ratio to growth ratio
CAGR = compounded annual growth rate	FY = financial year	q-o-q = quarter-on-quarter
Capex = capital expenditure	m = million	RM = Ringgit
CY = calendar year	M-o-m = month-on-month	ROA = return on assets
Div yld = dividend yield	NAV = net assets value	ROE = return on equity
DCF = discounted cash flow	NM = not meaningful	TP = target price
DDM = dividend discount model	NTA = net tangible assets	trn = trillion
DPS = dividend per share	NR = not rated	WACC = weighted average cost of capital
EBIT = earnings before interest & tax	p.a. = per annum	y-o-y = year-on-year
EBITDA = EBIT before depreciation and amortisation	PAT = profit after tax	YTD = year-to-date

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