CLSA ASIA-PACIFIC MARKETS

# Hartalega

**RM5.41 - BUY**

Results review


## Saurabh Chugh
saurabh.chugh@clsa.com
(60) 320567872


**09 November 2011**

## Malaysia
## Healthcare

| | |
|---|---|
| Reuters | HTHB.KL |
| Bloomberg | HART MK |

**Priced on 4 November 2011**
KLSE Comp @ 1,477.5

**12M hi/lo** RM6.08/4.85

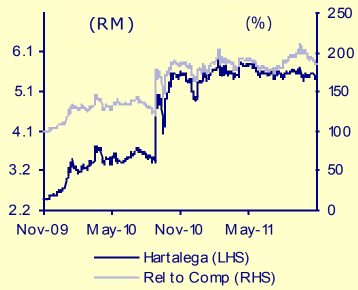
| | |
|---|---|
| **12M price target** | RM7.30 |
| **±% potential** | +35% |
| **Target set on** | 14 Sep 11 |
| **Shares in issue** | 363.5m |
| **Free float (est.)** | 44.3% |
| **Market cap** | US$631m |

**3M average daily volume**
RM1.4m (US$.5m)

**Major shareholders**
Hartalega Industries 50.6%
Budi Tenggara 5.1%

### Stock performance (%)

| | 1M | 3M | 12M |
|---|---|---|---|
| Absolute | (2.7) | (0.6) | (1.6) |
| Relative | (8.0) | 0.6 | 1.0 |
| Abs (US$) | (1.6) | (4.0) | (2.8) |




Source: Bloomberg

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# 2QFY11 results - In line

**Hartalega's 2QFY11 results were broadly in line with core net profit coming in at 26% of our full year estimates. Revenue was up 5% QoQ but core net profit (excluding fx hedging loss) was flat QoQ implying margin contraction. Although we expect Hartalega's super high margins to normalise as competition increases, its return on capital will remain far superior to other glove manufacturers. At 9.5x FY12 earnings stock looks inexpensive compared to other glove manufacturers as well as the Malaysian market. Maintain BUY**

### 2QFY11 results – in line
Hartalega top line expanded 5% QoQ (25% YoY) to RM230m driven by increase in ASP's although volume growth was flat QoQ. Reported net profit was down 16% QoQ mainly because of fx fair value hedging loss of RM8.4m. Adjusting for exceptionals core net profit came was roughly flat QoQ at RM53m. 6mFY12 net profit of RM108m was 52% of our full year forecasts.

### Margins contract as expected
EBIT margins contracted by 2.6ppts QoQ to 29.9% but still remain at least 10-15ppts higher than competition. By comparison Top Glove's operating margin is only 6.4%. We are expecting margins to contract 5ppts YoY on a full year basis as high raw material prices coupled with increase in competition imply increase in costs cannot be completely passed through. However, as Hartalega is exposed to the high end segment with strong customer relationships we expect contraction in margins to less severe than witnessed by Top Glove following capacity expansion in the natural latex segment.

### Declining raw material prices could help sustain margins
Both the raw materials used in making nitrile rubber i.e. acrylonitrile and butadiene have seen a sharp correction in prices over last 3-4 months. However, has NBR is not traded and mostly bought on contracts we expect some delay in suppliers passing on benefits to Hartalega but over next 3-6 months expect falling raw material prices to mitigate margin contraction.

### Cheap for its return profile
At 9.5x FY12 earnings Hartalega trades at a sharp discount to Top Glove, sector average and even the Malaysian market. With ROIC>40% and steady long term growth expectations of 8-10% stock looks extremely cheap on most metrics for its return profile. Expect re rating in line with peers and market multiples as liquidity in the stock improves. Maintain BUY.

### Financials

| Year to 31 Mar | 10A | 11A | 12CL | 13CL | 14CL |
|---|---|---|---|---|---|
| Revenue (RMm) | 572 | 735 | 948 | 999 | 1,162 |
| Net profit (RMm) | 143 | 190 | 208 | 215 | 240 |
| EPS (sen) | 39.3 | 52.4 | 57.1 | 59.1 | 65.9 |
| CL/consensus (8) (EPS%) | - | - | 100 | 92 | 88 |
| EPS growth (% YoY) | 69.1 | 33.2 | 9.1 | 3.5 | 11.6 |
| PE (x) | 13.8 | 10.3 | 9.5 | 9.2 | 8.2 |
| Dividend yield (%) | 2.5 | 3.9 | 4.8 | 4.9 | 5.5 |
| FCF yield (%) | 4.9 | 6.1 | 9.4 | 7.3 | 11.2 |
| PB (x) | 5.6 | 4.2 | 3.4 | 2.8 | 2.4 |
| ROE (%) | 47.0 | 46.3 | 39.5 | 33.5 | 31.3 |
| Net debt/equity (%) | (9.4) | (17.3) | (30.2) | (32.7) | (42.0) |

Source: CLSA Asia-Pacific Markets

# 2QFY11 results - In line

Hartalega'S 2QFY11 results were broadly in line with our estimates after adjusting for fair value adjustment loss of Rm8.4m on fx forward contracts. Top line growth was steady with European sales driving 5% QoQ growth in revenues. EBIT margins however contracted due to a combination of rising raw material prices and increasing competition in the nitrite segment. Core net profit however came in slightly ahead with 6mFY12 core profit of RM108m or 52% of full year estimates.

**Revenue growth driven by ASP expansion but higher raw material costs led to some contraction in margins**

Figure 1

**2QFY12 results snapshot**

| RMm | 2Q FY11 | 1Q FY12 | 2Q FY12 | 6M FY12 | % YoY | % QoQ | % of CL |
|---|---|---|---|---|---|---|---|
| Revenue | 184.3 | 219.4 | 229.5 | 448.9 | 24.5 | 4.6 | 47.4 |
| Ope expenses | (124.8) | (143.6) | (164.0) | (307.7) | 31.4 | 14.2 | - |
| Other op income | 2.2 | 4.6 | 3.2 | 7.8 | 45.9 | (31.7) | - |
| EBITDA | 68.7 | 80.5 | 79.4 | 159.9 | 15.6 | (1.3) | 53.8 |
| Depreciation | (7.1) | (9.2) | (10.8) | (20.0) | 52.7 | 17.1 | - |
| Op. profit | 61.6 | 71.2 | 68.7 | 139.9 | 11.4 | (3.6) | 52.7 |
| Finance costs | (0.6) | (0.5) | (0.4) | (0.9) | nm | nm | - |
| Forex/EI | 1.6 | 0.1 | (8.7) | (8.6) | nm | nm | |
| PBT | 61.0 | 70.7 | 59.6 | 130.2 | (2.4) | (15.7) | 48.9 |
| Core PBT | 59.4 | 70.6 | 68.2 | 138.8 | 14.8 | (3.4) | 52.1 |
| Taxation | (13.9) | (15.9) | (13.4) | (29.3) | (3.8) | (16.0) | 73.6 |
| PAT | 47.1 | 54.8 | 46.2 | 101.0 | (2.0) | (15.8) | - |
| MI | (0.0) | (0.0) | 0.0 | 0.0 | nm | nm | - |
| Net profit | 47.1 | 54.8 | 46.1 | 100.9 | (2.1) | (15.9) | 48.6 |
| Core Net profit | 45.5 | 54.7 | 52.9 | 109.5 | 20.6 | 0.4 | 51.8 |
| EPS | 13.0 | 15.1 | 12.7 | 27.7 | (2.2) | (15.8) | - |
| Core EPS | 12.5 | 15.1 | 14.5 | 30.1 | 20.4 | 0.1 | 51.8 |

Source: CLSA Asia-Pacific Markets

**Sudden MYR weakness in September resulted fx hedging losses of RM8.6m**

Figure 2

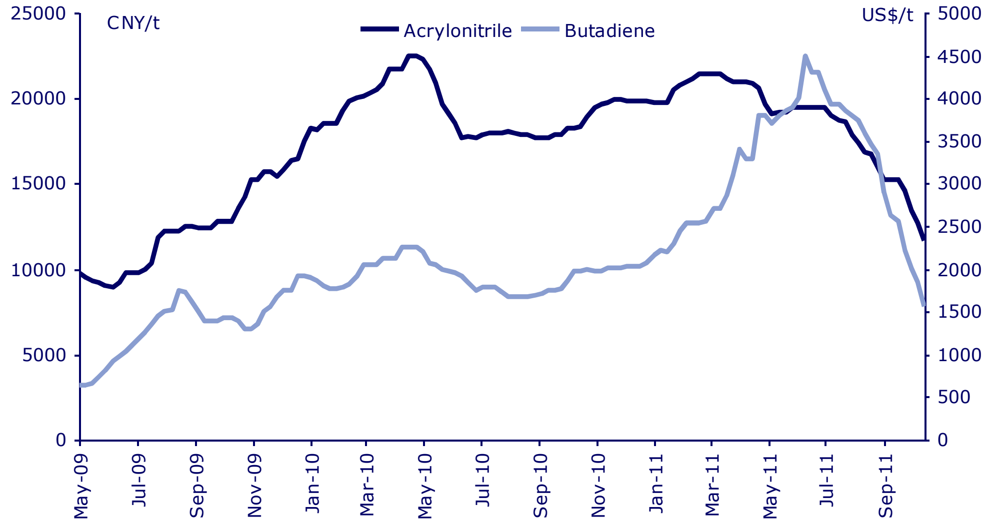
**Sharp weakening of MYR**


Source: CLSA Asia-Pacific Markets, Bloomberg

**Sharp reduction in both acryolnitrile and butadiene prices should result in a correction in NBR prices....although with a lag as it is not a traded commodity**

Figure 3

**Acrylonitrile and butadiene prices**

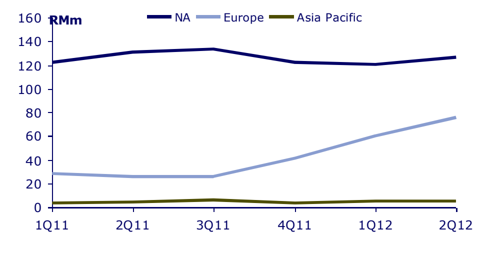



Source: CLSA Asia-Pacific Markets

**Europe has been the key growth driver for Hartalega and now accounts for over third of total revenues**

Figure 4

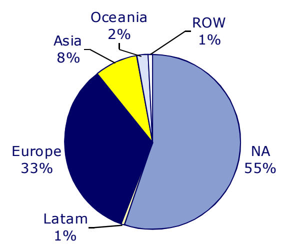
**Revenue growth by market**




Source: CLSA Asia-Pacific Markets

Figure 5

**Revenue breakdown by market**



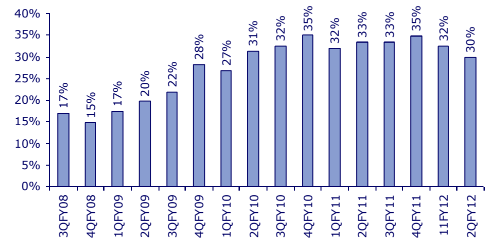

Source: CLSA Asia-Pacific Markets

**Margins contracted by 2.6 ppts in last quarter due to increased competition as expected by still remain significantly above peers;**

**We are factoring in EBIT margin of 28% for FY3/12 as compared to 31.2% reported for the first six months of the year**

Figure 6

**EBIT margins**




Source: CLSA Asia-Pacific Markets

Figure 7

**12m rolling ROE**


Source: CLSA Asia-Pacific Markets

**Balance sheet remain strong**

Figure 8

### Receivable days

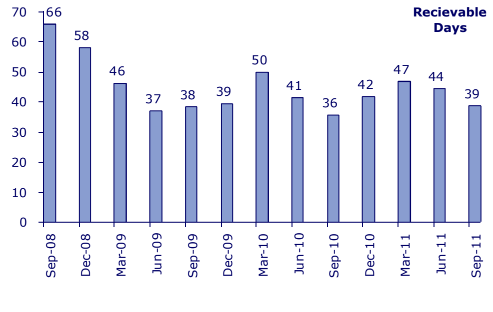
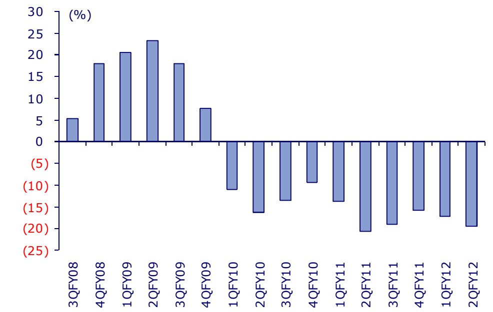



Figure 9

### Net gearing

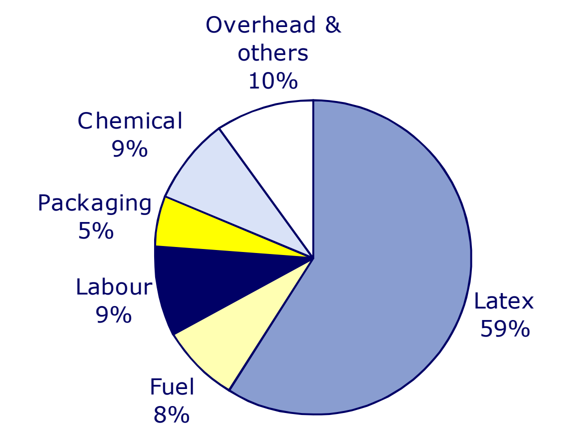



Source: CLSA Asia-Pacific Markets

**Share of latex as percentage of total costs should decline going forward as nitrile prices correct**

Figure 10

### 2QFY12 cost breakdown




Source: CLSA Asia-Pacific Markets

**Significantly cheap for its growth and return profile**

### Reasonable valuations and attractive dividend yield

We derive our target price of RM7.3 by applying the Malaysian market multiple 12.4x to 2012 earnings. The company is currently trading at 9.5x FY12 earnings however be believe the company's superior competitive positioning and high ROE's should warrant a rerating at least in line with market multiples. In addition the company has recently announced an increase in its payout ratio to 45% which translates into a dividend yield of roughly 5% thus implying a TSR of 40%. BUY.

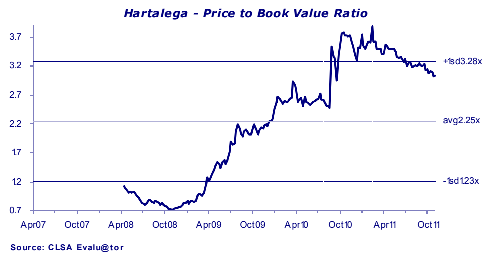
**Historical valuation charts not reflective of structural improvement in return profile**

Figure 11

### Historical P/E


Figure 12

### Historical P/B




Source: CLSA Asia-Pacific Markets

evalu@tor® The Asia-Pacific Market Database

# Summary financials

| Year to 31 March | 2010A | 2011A | 2012CL | 2013CL | 2014CL |
|---|---|---|---|---|---|
| **Summary P&L forecast (RMm)** | | | | | |
| **Revenue** | **572** | **735** | **948** | **999** | **1,162** |
| Op Ebitda | 200 | 271 | 297 | 311 | 343 |
| Op Ebit | 180 | 242 | 265 | 273 | 302 |
| Interest income | 1 | 3 | 4 | 6 | 8 |
| Interest expense | (3) | (2) | (3) | (3) | (3) |
| Other items | 0 | 0 | 0 | 0 | 0 |
| **Profit before tax** | **178** | **243** | **266** | **276** | **308** |
| Taxation | (35) | (53) | (59) | (61) | (68) |
| Minorities/Pref divs | 0 | 0 | 0 | 0 | 0 |
| **Net profit** | **143** | **190** | **208** | **215** | **240** |
| **Summary cashflow forecast (RMm)** | | | | | |
| **Operating profit** | **180** | **242** | **265** | **273** | **302** |
| Operating adjustments | 0 | 0 | 0 | 0 | 0 |
| Depreciation/amortisation | 20 | 29 | 32 | 38 | 41 |
| Working capital changes | (15) | (20) | (1) | (3) | (2) |
| Net interest/taxes/other | (22) | (55) | (61) | (63) | (70) |
| **Net operating cashflow** | **163** | **195** | **235** | **244** | **270** |
| Capital expenditure | (67) | (75) | (50) | (100) | (50) |
| **Free cashflow** | **96** | **120** | **185** | **144** | **220** |
| Acq/inv/disposals | 0 | 0 | 0 | 0 | 0 |
| Int, invt & associate div | 1 | 3 | 4 | 6 | 8 |
| **Net investing cashflow** | **(65)** | **(72)** | **(46)** | **(94)** | **(42)** |
| Increase in loans | (15) | 0 | 0 | 0 | 0 |
| Dividends | (45) | (76) | (93) | (97) | (108) |
| Net equity raised/other | 0 | 0 | 0 | 0 | 0 |
| **Net financing cashflow** | **(60)** | **(76)** | **(93)** | **(97)** | **(108)** |
| **Incr/(decr) in net cash** | **38** | **48** | **95** | **53** | **121** |
| Exch rate movements | (1) | 0 | 0 | 0 | 0 |
| **Opening cash** | **38** | **75** | **122** | **217** | **270** |
| **Closing cash** | **75** | **122** | **217** | **270** | **391** |
| **Summary balance sheet forecast (RMm)** | | | | | |
| Cash & equivalents | 75 | 122 | 217 | 270 | 391 |
| Debtors | 83 | 107 | 137 | 145 | 169 |
| Inventories | 28 | 41 | 31 | 30 | 25 |
| Other current assets | 0 | 0 | 0 | 0 | 0 |
| Fixed assets | 293 | 339 | 357 | 419 | 428 |
| Intangible assets | 0 | 0 | 0 | 0 | 0 |
| Other term assets | 0 | 0 | 0 | 0 | 0 |
| **Total assets** | **479** | **609** | **743** | **865** | **1,013** |
| Short-term debt | 14 | 14 | 14 | 14 | 14 |
| Creditors | 44 | 61 | 80 | 83 | 100 |
| Other current liabs | 11 | 11 | 11 | 11 | 11 |
| Long-term debt/CBs | 28 | 28 | 28 | 28 | 28 |
| Provisions/other LT liabs | 28 | 28 | 28 | 28 | 28 |
| Minorities/other equity | 0 | 0 | 0 | 1 | 1 |
| Shareholder funds | 354 | 468 | 582 | 700 | 832 |
| **Total liabs & equity** | **479** | **609** | **743** | **865** | **1,013** |
| **Ratio analysis** | | | | | |
| Revenue growth (% YoY) | 29.0 | 28.5 | 28.9 | 5.4 | 16.4 |
| Ebitda growth (% YoY) | 86.9 | 35.6 | 9.8 | 4.5 | 10.3 |
| Ebitda margin (%) | 34.9 | 36.9 | 31.4 | 31.1 | 29.5 |
| Net profit margin (%) | 25.0 | 25.9 | 21.9 | 21.5 | 20.6 |
| Dividend payout (%) | 33.9 | 40.1 | 45.0 | 45.0 | 45.0 |
| Effective tax rate (%) | 19.5 | 21.6 | 22.0 | 22.0 | 22.0 |
| Ebitda/net int exp (x) | 95.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net debt/equity (%) | (9.4) | (17.3) | (30.2) | (32.7) | (42.0) |
| ROE (%) | 47.0 | 46.3 | 39.5 | 33.5 | 31.3 |
| ROIC (%) | 44.7 | 49.6 | 48.7 | 45.5 | 46.5 |
| EVA®/IC (%) | 34.0 | 38.9 | 38.0 | 34.8 | 35.9 |

Source: CLSA Asia-Pacific Markets

**Recommendation history - Hartalega Holdings Bhd HART MK**

| Date | Rec level | Closing price | Target |
|---|---|---|---|
| 14 September 2011 | BUY | 5.55 | 7.30 |
| 19 March 2011 | BUY | 5.55 | 7.40 |

Source: CLSA Asia-Pacific Markets

**Key to CLSA investment rankings: BUY** = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).