

02 October 2019

Rubber Gloves

Demand To Bounce Up

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OVERWEIGHT



Maintain OVERWEIGHT. Our investment case is based on: (i) our analysis that the new capacity expansion industry-wide is slower-than-expected, which should help maintain the supply-demand equilibrium, (ii) expected earnings growth driven by new capacity expansion and higher ASPs, and (iii) US-led uptick in demand due to trade war where the US accounts for between 28%-55% of glove players group sales. Due to the intense competition in the latex segment, we would focus on players which are largely nitrile-centric including HARTA and KOSSAN. We have OUTPERFORM calls on HARTA (OP; TP: RM5.85); KOSSAN (OP; TP: RM5.25) and SUPERMX (OP; TP: RM1.75). Our Top Pick in the sector is HARTA (OP; TP: RM5.85). We like HARTA for: (i) its “highly automated production processes” model, which is moving from ‘good’ to ‘great’ as they are head and shoulders above peers in terms of better margins and costs reduction, (ii) constantly evolving via innovative products development, and (iii) its nitrile gloves segment, which is booming.



2QCY19 results were a mixed bag. The recent 2QCY19 results season for glove makers under our coverage came in mixed. The star performer was Kossan which recorded a 30% YoY net profit growth, underpinned by new capacity expansion in plant 16, 17 and 18. Hartalega saw a small sequential growth in 1Q20 (FYE Mar), we are expecting better performance in subsequent quarters on the back of uptick in demand and potential margins expansion emanating from operating efficiency and better economies of scale due to increased capacity and higher volume sales. Supermax's 4Q19 was hit by competition in the latex segment and an up-trending input rubber latex price and a one-off cost which dragged down overall 4Q19 bottom-line. Top Glove suffered 2nd consecutive quarterly earnings disappointment.

Expect US demand to surge from trade-war effect. Due to the impact of trade war whereby effective Sept 1, a 15% tariff will be imposed on Chinese-made medical and vinyl gloves, local rubber glove players expect to see an uptick in demand for gloves of which the positive impact is expected to be felt from the Dec-ending quarter period. Theoretically, the tariff hike is expected to increase the price for Chinese-made gloves, which could compel a switch of US gloves demand to Malaysia glove players where US accounts for between 28%-55% of glove players' group sales.

Uptick in nitrile demand but intense competition for latex to hit margin. Looking ahead, the keen competition in the latex segment could negatively impact latex gloves margin. The robust demand for nitrile gloves has led to longer delivery lead times to between 45 to 50 days as compared to 30 to 40 days previously. Although we are positive on growth in subsequent quarters underpinned by uptick in nitrile demand driven by re-stocking activities, players like TOPGLOV and SUPERMX could continue to be plagued with competitive pressure from low margin latex gloves (accounts for estimated 50% of product mix for both players) which could offset the gains in the nitrile segment.

Investors should focus on nitrile-centric players. Due to the intense competition in the latex segment, we recommend players which are largely nitrile-centric including HARTA and KOSSAN which product mixes hinge largely towards nitrile at 95% and 75% share, respectively. Conversely, TOPGLOV and SUPERMX which are largely latex-centric with product mix between nitrile and latex are estimated at 50% : 50% are expected to face margins pressure.

Oversupply concerns overplayed, ASPs pressure temporary rough patch. From our analysis, there are nascent signs indicating that oversupply concerns appear overplayed considering that capacity expansions of the four rubber gloves under coverage are expected to be delayed and staggered. In the last two years, the sector has become a victim of its own success. The frantic pace of capacity expansion has resulted in a mild excess supply for rubber gloves leading to ASP compressions and flatish or lower profits over the past two quarters. However, with the rubber gloves players becoming aware of the intense competition since four months ago, measures were taken to mitigate the impact of competition including; (i) slowing new capacity expansion, (ii) measures to maintain margins, including automation and other cost reduction initiatives, and (iii) intensifying sales efforts to penetrate emerging economies.

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Maintain OP on Kossan. We like Kossan because it is trading at an unwarranted 28% discount to peers' PER average considering that its net profit growth is the highest at 23.7% compared to peers average at 7%. Our TP is RM5.25 based on 25.5x FY20E EPS (+1.0SD above 5-year historical forward mean).

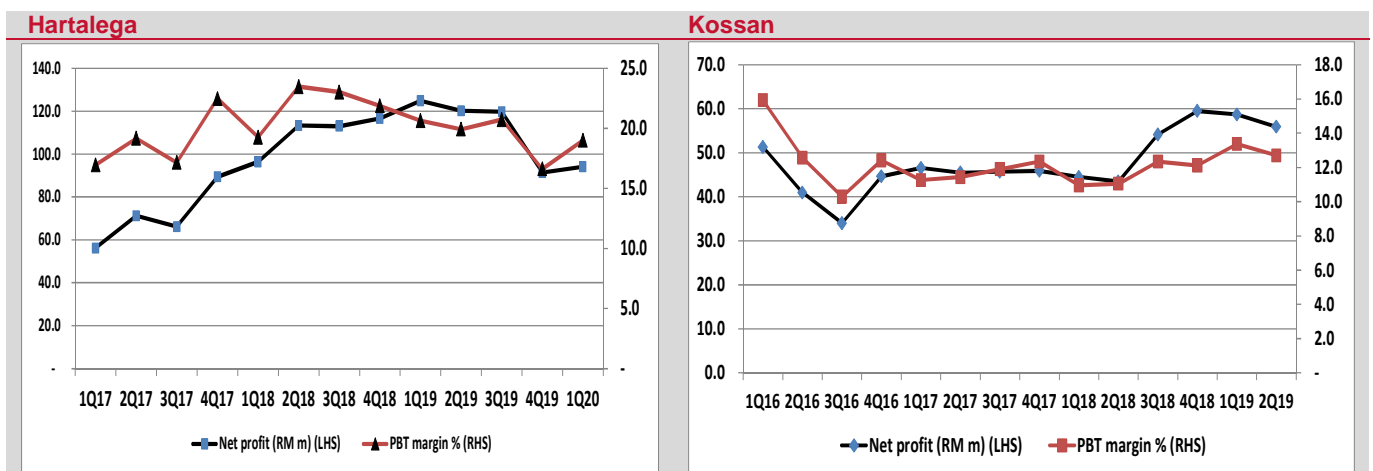


KEY POINTS

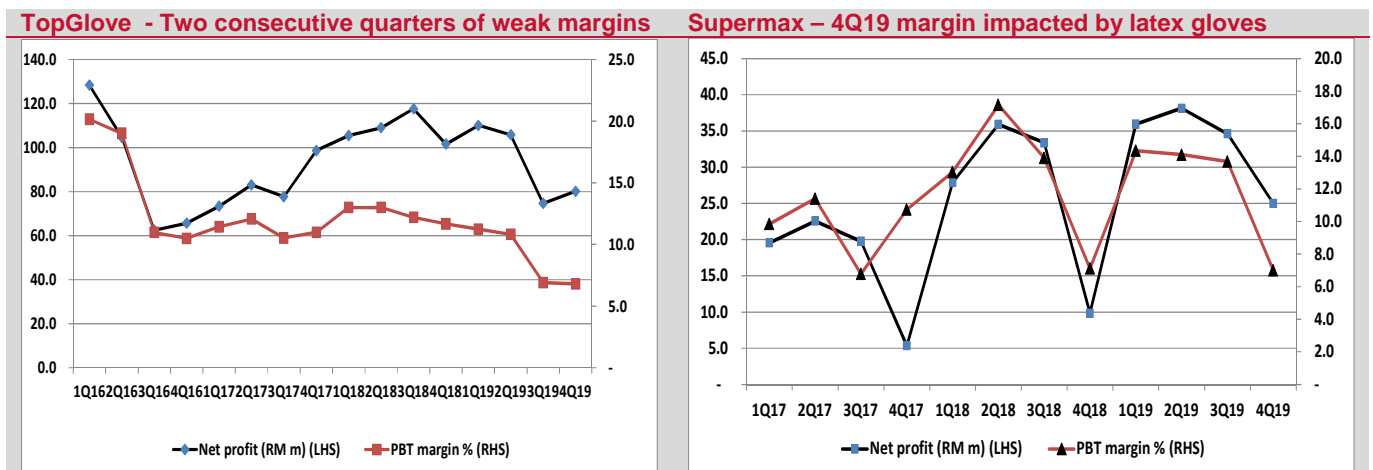
Expect US demand to surge from trade-war effect. Due to the impact of trade war whereby effective Sept 1, a 15% tariff will be imposed on Chinese-made medical and vinyl gloves, local rubber glove players expect to see an uptick in demand for gloves of which the positive impact is expected to be felt from the Dec-ending quarter period. Theoretically, the tariff hike is expected to increase the price for Chinese-made gloves, which could compel a switch of US gloves demand to Malaysia glove players where the US accounts for between 28%-55% of glove players' group sales

Uptick in nitrile demand but intense competition for latex to hit margin. Looking ahead, the keen competition in the latex segment could negatively impact latex gloves margin. The robust demand for nitrile gloves has led to longer delivery lead times to between 45 to 50 days as compared to 30 to 40 days previously. Although we are positive on growth in subsequent quarters underpinned by uptick in nitrile demand driven by re-stocking activities, players like TOPGLOV and SUPERMX could continue to be plagued with competitive pressure from low margin latex gloves (accounts for estimated 50% of product mix for both players) which could offset the gains in the nitrile segment.

Investors should focus on nitrile-centric players. Due to the intense competition in the latex segment, we recommend players which are largely nitrile-centric including HARTA and KOSSAN which product mixes hinge largely towards nitrile at 95% and 75% share, respectively. Conversely, TOPGLOV and SUPERMX which are largely latex-centric with product mix between nitrile and latex are estimated at 50% : 50% are expected to face margins pressure.



Source: Bloomberg, Kenanga Research



Source: Bloomberg, Kenanga Research

Oversupply concerns overplayed, supply/demand dynamics appears in equilibrium. We now believe signs of oversupply concerns appear overplayed, considering that capacity expansion of the four players under our coverage is expected to be delayed and staggered. Kossan's 5.5b pieces capacity is only expected to be gradually ramped up starting from 3Q and 4Q 2019. Top Glove's planned capacity has been scaled back and it only expects effective 2.6b pieces new capacity by end 2019. Hartalega's new capacity is estimated at 4.0b pieces in 2019. If we aggregate these numbers up, the total new capacity is only about 11.6b pieces or 15.5b pieces if grossed up (assuming all the four listed players under our coverage account for an estimated average 75% of total production in Malaysia) compared to an estimated demand of 17.5b pieces (if we take global demand at 270b pieces of gloves and assuming a 10% growth, new demand is expected at 27b pieces and Malaysia accounts for 65% of market share globally), the supply/demand dynamics appears in equilibrium. Furthermore, most glove manufacturers can only run at an average maximum utilisation rate of 90% due to required downtime for maintenance while industry capacity expansions are only coming in progressively over the next two years. We believe players are pro-active in carrying out measures having experienced various cycles of oversupply.

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Estimated incoming capacity indicating equilibrium supply-demand of rubber gloves

	Top Glove	Supermax	Kossan	Hartalega	Total
Estimated capacity in start CY2019 (bn pieces)	60.5	23.9	26.5	31.2	142.1
Estimated new capacity	2.6 [^]	2.0	3.0	4.0	11.6
Total estimated capacity by end CY2019	63.1	26.9	29.5	36.0	153.7
	Top Glove	Supermax	Kossan	Hartalega	Total
Estimated capacity in start of CY2020 (bn pieces)	63.1	26.9	29.5	36.0	155.5
Estimated new capacity	5.0 [*]	3.0	4.0	4.6	16.6
Total estimated capacity by end CY2020	68.1	28.9	33.5	40.6	172.1

Estimated new supply from Malaysia and new world demand in 2019

(a) Estimated world demand (b pieces)	270.0b
(b) Estimated new demand growth = 10%	27.0b
(c) Top four (Kossan, Supermax, Top Glove and Hartalega) new incremental net capacity increase in CY19	11.6
(d) Malaysia accounts for 65% world market share and new demand = (b) x 65%	17.5
(e) Total estimated of new supply in Malaysia (assumption : Top four accounts for an estimated 75% to total production in Malaysia)	15.5

Estimated new supply from Malaysia and new world demand in 2020

(a) Estimated world demand (b pieces)	297.0b
(b) Estimated new demand = 10% growth	29.7b
(c) Top four (Kossan, Supermax, Top Glove and Hartalega) new incremental net capacity increase in CY20	16.6
(d) Malaysia accounts for 65% world market share and new demand = (b) x 65%	19.3
(e) Total estimated of new supply in Malaysia (assumption: Top four accounts for an estimated 75% to total production)	22.1

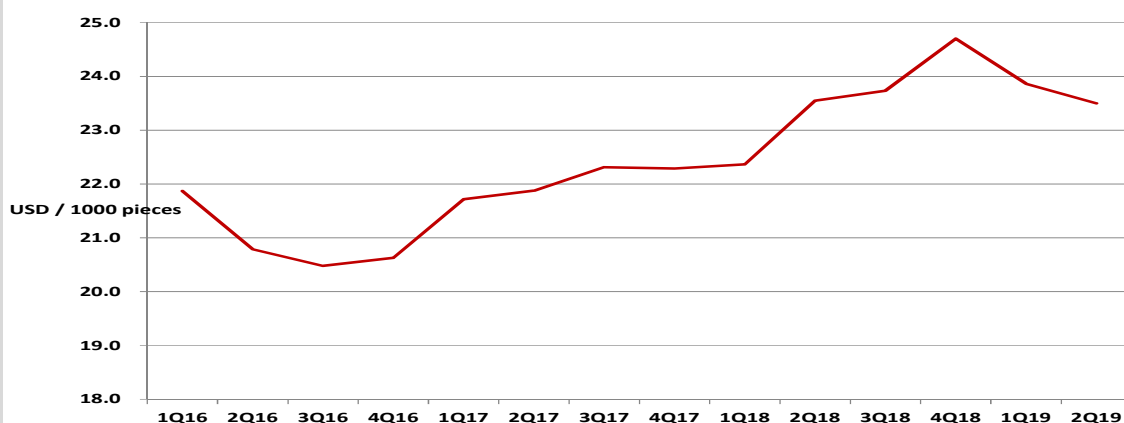
Source: Companies, Kenanga Research

[^]planned capacity is 5.4b pieces, effective is 2.6b pieces

^{*}planned capacity is 17.4b pieces, effective is 5.0b pieces

ASPs pressure, Temporary rough patch. In the last two years, the sector has become a victim of its own success. The frantic pace of capacity expansion resulted in a mild excess supply for rubber gloves leading to ASPs compression and flattish or lower profits over the past two quarters. However, we take comfort that this is nothing more than just a temporary rough patch. However, with the rubber gloves players becoming aware of the intense competition since four months ago, among measures taken to mitigate the competitive impact were; (i) slowing down new capacity expansion, (ii) more measures to maintain margins, including automation and other cost reduction initiatives, and (iii) intensifying sales efforts to penetrate emerging economies. The past two oversupply cycles lasted about 6-9 months. Having experienced various cycles of oversupply, we believe players are now better at responding to competitive pressure. Hence, we see the ASPs pressure problem in the sector sorting itself out within another quarter. Based on the chart below, rubber glove players' ASPs appears stable in 1Q19 despite competitive pressure. Due to the lag effect in passing cost through as a result of higher natural gas and raw material (latex), we understand that some players have raised ASPs by 3-6%, which should help to contain high operating costs and put brakes on further margin compression in subsequent quarters. Recall, while pricing adjustments were made accordingly, there was a time lag of two months before the cost increase could be shared out with customers. Furthermore, we expect price competition in the nitrile glove segment to mildly subside on the back of delayed incoming capacities, which could ease downwards pressure on ASPs.

Rubber Gloves ASPs/1000 pieces – stable



Source : Industry, Kenanga Research

Expecting raw material inputs to trade lower or maintain at current price levels going forward. Latex price appears to trend upwards during the seasonal wintering months starting end-Dec till May (please see chart below). In anticipation of shortage in latex production supply during the wintering months, latex price has risen 33% to RM5.04/kg YTD 2019. Based on industry checks, natural latex price is expected to hover between RM4.50/kg and RM6.50/kg. We are not overly concerned because at these levels, players can still manage to pass cost through. We expect both input raw material price of latex and nitrile to stay flat at least over the medium term. Despite reports that Thailand, Indonesia and Malaysia have agreed to cut natural rubber exports by 240,000 tonnes from April to July this year, we expect prices to stabilize due to slower world demand. According to the International Rubber Study Group (IRSG), global demand for latex/rubber should rise about 2.5% in 2019 to >30m metric tons. The IRSG's forecast world demand for natural rubber (NR) production is projected at 2.6% and 2.3%, respectively in 2019 and 2020. Similarly, consumption in China, which accounts for an estimated 40% of world consumption, is anticipated to take a slower track by increasing only by 3.2% in 2019, compared to the 5.3% of growth preliminarily estimated for 2018 and the 7.5% growth attained in 2017.

Natural latex price appears to taper off post wintering season



Source: Bloomberg, Kenanga Research

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Maintain OP on Kossan. We like Kossan because it is trading at an unwarranted 25% discount to peers’ PER average considering that its net profit growth is the highest at 23.7% compared to peers average at 7%.

Maintain OP on Supermax. We like Supermax because: (i) the stock is trading at an unjustifiable 40% discount to peers’ average compared to a historical discount of 30%, and (ii) it is a prime beneficiary of a favourable USD/MYR forex since they do not hedge their sales receipts.

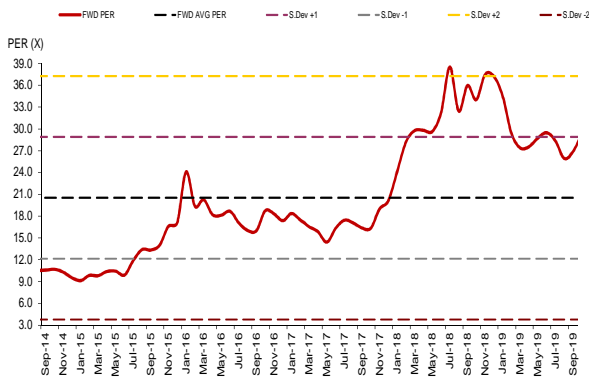
Maintain OVERWEIGHT. Our investment case is based on: (i) our analysis that the new capacity expansion is slower-than-expected, which should help maintain the supply-demand equilibrium, (ii) earnings growth to resume in subsequent quarters, boosted by higher ASPs, and (iii) weakening of the MYR against the USD. Based on current valuations, we believe all the negatives are largely priced in, and gloves stocks are now trading slightly above their respective mean, which appears undemanding.

Rubber Gloves

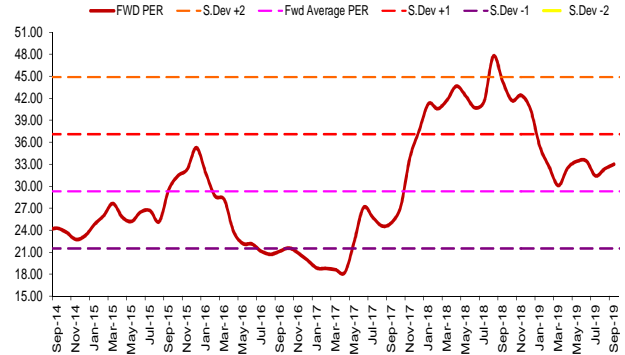
Company	Target Price (RM)	Valuation basis
Kossan Rubber	5.25	based on 25.5x CY20E EPS (+1.0SD above 5-year historical forward mean)
Hartalega	5.85	based on 36x CY20E EPS (at +1.0SD above 5-year historical forward mean)
Top Glove	4.00	based on 25.5x CY20E EPS (+1.0SD above 5-year historical forward mean)
Supermax	1.75	based on 17.5x CY20E EPS (at +1.0SD above its historical forward mean)

Source: Companies, Kenanga Research

Top Glove - Forward PER

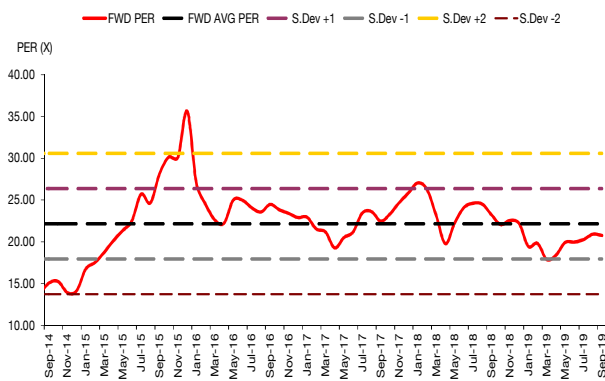


Hartalega - Forward PER

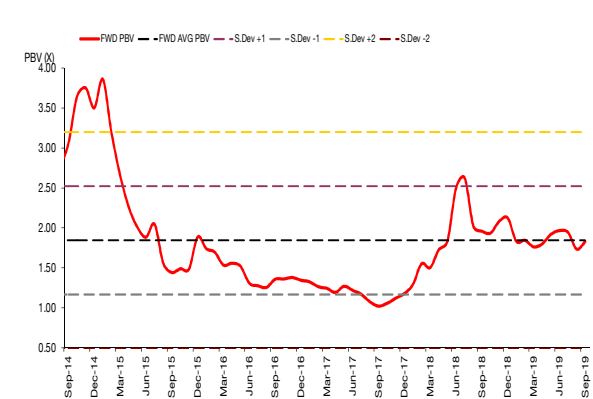


Source: Bloomberg, Kenanga Research

Kossan - Forward PER



Supermax - Forward PER



Source: Bloomberg, Kenanga Research

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Peer Comparison

Name	Price @ 20/9/19 (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net Div Yld (%)	Target Price (RM)	Rating
					1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.			
RUBBER GLOVES																	
HARTALEGA HOLDINGS BHD	5.26	17674	Y	03/2020	3.7	6.2	11.6	6.7	38.0	34.1	31.9	7.7	6.9	20.3	1.3	5.85	OP
KOSSAN RUBBER INDUSTRIES	4.21	5384	Y	12/2019	8.4	4.4	23.7	6.0	26.8	21.7	20.4	4.1	3.6	16.7	1.4	5.25	OP
SUPERMAX CORP BHD	1.58	2064	Y	06/2020	2.8	6.0	4.1	6.3	16.9	16.2	15.3	1.9	1.8	11.1	2.5	1.75	OP
TOP GLOVE CORP BHD	4.75	12159	Y	08/2020	6.3	-5.5	5.4	8.9	32.6	31.0	28.4	5.0	4.4	14.3	1.6	4.00	UP

Source: Bloomberg, Kenanga Research

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Stock Ratings are defined as follows:

Stock Recommendations

- OUTPERFORM : A particular stock's Expected Total Return is MORE than 10%
- MARKET PERFORM : A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
- UNDERPERFORM : A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

- OVERWEIGHT : A particular sector's Expected Total Return is MORE than 10%
- NEUTRAL : A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
- UNDERWEIGHT : A particular sector's Expected Total Return is LESS than -5%

*****Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.**

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