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Malaysia Healthcare

Hartalega HART MK
Rec O-PF→BUY
Market cap US\$3.8bn
Price RM4.83
Target RM5.60→RM6.00
Up/downside +24%

Kossan KRI MK
Rec SELL→BUY
Market cap US\$1.1bn
Price RM3.66
Target RM3.65→RM4.85
Up/downside +33%

Top Glove TOPG MK
Rec U-PF→O-PF
Market cap US\$2.8bn
Price RM4.67
Target RM4.65→RM5.40
Up/downside +16%

The spoils of war

Glove sector to ride the trade war volatility

Amid volatility, glovemakers represent one of a few sectors to emerge as a potential beneficiary of the trade war. The increase in price for Chinese-made gloves could induce a switch of US glove demand to Malaysia, rendering the concern of oversupply moot. Following the sell-down in January 2019, moderate valuations render risk-reward favourable at this juncture. We thus upgrade the sector to O-WT (from Neutral) with Hartalega (BUY) our top pick given it has the highest exposure to the US market (56%).

Deja-vu: supply-demand dynamics to mirror 2017

- The US tariff hike to 25% is set to narrow the price gap between vinyl and nitrile gloves, inducing a switch as China glove manufacturer competitiveness fades.
- Recall in 2017 at the height of the Chinese environment clampdown, Malaysia's glovemakers recorded strong QoQ volume growth figure (+10-14% QoQ).
- Media reports cited a further widening of said US tariffs to all remaining imports from China, which could include medical and surgical gloves and could affect the going concern over smaller Chinese glovemakers.

Potential upside from currency

- We leave our US\$:RM assumption at RM4.13-RM4.14 (close to current spot) for now in view of trade tension volatility, which is set for further development.
- Nonetheless, this could be a potential upside risk to earnings in the event the US dollar strengthens against the ringgit given revenue is 100% US dollar denominated.
- Our currency sensitivity analysis indicates that every 1% swing in US\$:MR rate results in a 2.5%-4.9% change in our FY19-20CL earnings forecast.

1Q19 weakness to persist from front loading and currency spike

- Notwithstanding, we still expect weakness in glovemakers' 1Q19 results given the QoQ currency spike, and likely front loading in anticipation of the trade war.
- The knock-on effect of front loading is increased competition, which results in a restraint to ASP upward adjustments, increasing the likelihood of cost absorption.
- This is exacerbated by the increase in minimum wage and utility costs (8%-12% and 12%-15% of costs).

Upgrade to O-WT: risk-reward turns for the better given Jan 2019 sell down

- The above events render any margin downside risk moot as the cost pass-through mechanism returns to full form, enabling full earnings upside from capacity additions.
- We increase our ASP assumptions across the board resulting in an upgrade from O-PF to BUY for Hartalega. We raise our PE multiple peg to +1 std. (similar to 2017) which cumulates to upgrades for Kossan, from SELL to BUY, and U-PF to O-PF for Top Glove.

Glovesmaker five-year forward PE



US tariff hike includes
China vinyl gloves

Further escalation
according to media reports

Price gap between vinyl and
nitrile gap expected to
narrow

Plastic and rubber glove
imports split c.50:50

Malaysian glovemakers to
see strong demand akin to
2017

The spoils of war

Deja-vu: supply-demand dynamics to mirror 2017

The US has raised the tariff rate on US\$200bn in Chinese exports to 25%. Details are scant at this juncture, but on the assumption that the items in List 3 (refer to HTS code 4015.90.00: 'Seamless gloves of vulcanized rubber other than hard rubber, other than surgical or medical', vinyl gloves are not classified as medical, rather as examination gloves) released in September 2018 stand, the tariff hike would be applicable to vinyl gloves exported from China to the US.

While we kept our earnings and recs unchanged pending China's response, it is now apparent that our initial thought process that this would come to a settlement between the two nations is out the window following the retaliation by China with their own tariffs, with media reports citing a further escalation by the US by next Monday, widening said tariffs to all remaining imports from China, which could include medical and surgical gloves, this could have longer term implications on the going concern of Chinese glovemakers.

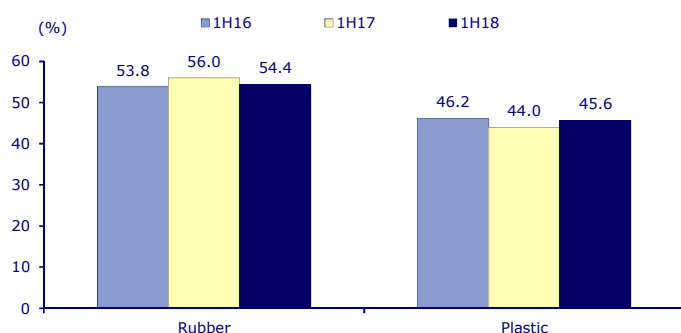
The US tariff hike to 25% is set to narrow the price gap between vinyl and nitrile gloves, which we think will induce partial switches as the China glove manufacturers' competitiveness fades.

It is a difficult to quantify the exact impact this outcome would have on supply demand dynamics, however the volume split between plastic and rubber is c.50:50; assuming the majority of plastic stems from China, the volume upside is potentially double for the rubber segment.

However, even in the event of 100% complete migration, the Malaysian glovemakers will not be able to absorb the additional demand due to capacity constraints, but the angle with this is them being able to fully utilise their production facilities, which in turn enables them to spread their fixed cost over more gloves, ultimately resulting in maintaining/increasing their margins. The chart further below shows the QoQ volume growth of the 3 glovemakers under coverage, and you can see exuberance in volumes in 2017 (during the height of the China environmental clampdown) particularly for Hartalega and Top Glove; with even Kossan managing some volume growth despite not adding any capacity during that period.

Figure 1

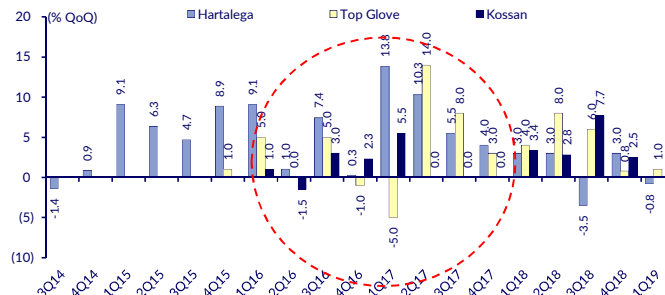
Glove imports by the US by type (%)



Source: MREPC

Figure 2

Glovemakers QoQ volume growth



Source: CLSA, various companies

Currency forecast
unattainable at this juncture

US dollar sensitivity defers
depending on the product
portfolio/US dollar debt

Still expect weakness in
1Q19

The ringgit strengthened
versus the US dollar in
1Q19

Potential upside from currency

While we leave our US\$:RM assumption at RM4.13-RM4.14 (close to current spot) for now in view of trade tension volatility, which is set for further developments per above. Nonetheless, this could be a potential upside risk to earnings in the event the US dollar strengthens against the ringgit, with the added catalyst being the -25bps OPR announced by BNM recently.

For the uninitiated, the glovemaker's revenues are 100% US dollar denominated, while cost is partially denominated in US dollar. Our currency sensitivity analysis indicate every 1% swing in US\$ MYR result in a 2.5% - 4.9% change in our FY19/20CL earnings forecast.

Figure 3

Glovemakers US dollar sensitivity	
Impact	Comment
Hartalega	93:7 nitrile latex portfolio mix; 100% of debt denominated in US\$ We estimate every 1% change results in a 2.5% swing in FY20CL NP
Top Glove	40:60 nitrile latex portfolio mix; 91% of debt denominated in US\$ We estimate every 1% change results in a 4.9% swing in NP
Kossan	70:30 nitrile latex portfolio mix; 11% of debt denominated in US\$ We estimate every 1% change results in a 4.4% swing in NP

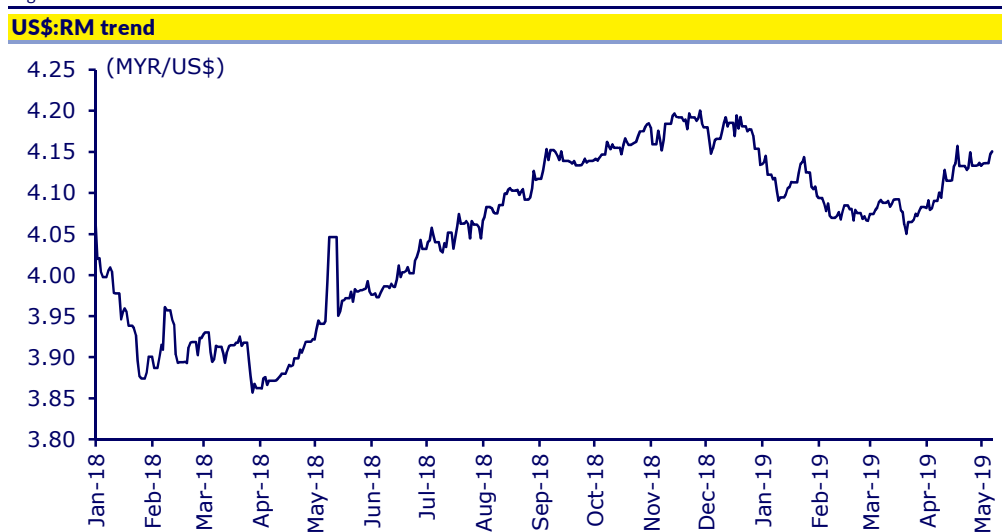
Source: CLSA, various companies

1Q19 weakness to persist from front loading; currency spike

Notwithstanding, we still expect weakness in 1Q19 results from glovemakers given the QoQ currency spike, which prevented glovemakers from adjusting their ASPs in time, as well as likely front loading from buyers in anticipation of the trade war.

The knock on effect of front loading is increased competition, which results in a restraint on ASP upward adjustments, increasing the likelihood of cost absorption. This is exacerbated by the increase in minimum wage and utility cost (8-12% and 12%-15% of cost).

Figure 4



Source: Bloomberg

Oversupply concerns
expected to abate

Upgrade to O-WT: risk-reward turns for the better post Jan 2019 sell-down

The downside risk to margins as a result of an expected oversupply environment as highlighted in our FY19 outlook note *Malaysia gloves (Hands off)* appears moot in light of the recent events, which we think could induce a re-rating in the sector to +1sd and above, akin to what transpired in FY17 driven by the environmental clampdown in China.

The sell-down at the beginning of the year renders risk reward favourable, with the sector now trading at 26x forward PE (trading mid-way between its five-year forward PE and +1 std, and at the average of its three-year forward PE). Hence, we upgrade the sector to O-WT (from Neutral).

Figure 5

Glovemakers: three-year forward PE



Source: CLSA

Figure 6

Glovemakers: five-year forward PE



Source: CLSA

We increase our ASP assumptions across the board, reducing the effect of the previously-assumed oversupply and consequently competitive environment. This results in an upgrade to BUY for Hartalega (from O-PF).

In addition, for Kossan and Top Glove, we raise our PE multiple peg to +1 std. of their respective five-year forward PEs (similar to 2017, prudently utilising five-year forward in an attempt to strip out the fund flow related elevation of multiples stemming from FBMKLIC inclusion) resulting in an upgrade to BUY for Kossan (from SELL) and O-PF for Top Glove (from U-PF).

Figure 7

Glovemaker assumption changes

ASPs (US\$/'000 gloves)	Current			Previous			Change (%)		
	FY20CL	FY21CL	FY22CL	FY20	FY21	FY22	FY20	FY21	FY22
Hartalega	23.90	23.31	23.07	23.42	22.95	22.72	2.1	1.5	1.5
	FY19CL	FY20CL	FY21CL	FY19CL	FY20CL	FY21CL	FY19CL	FY20CL	FY21CL
Kossan	27.62	27.62	27.62	27.34	27.34	27.34	1.0	1.0	1.0
	FY19CL	FY20CL	FY21CL	FY19CL	FY20CL	FY21CL	FY19CL	FY20CL	FY21CL
Top Glove	23.96	23.72	23.72	23.71	23.12	23.12	1.0	2.6	2.6

Source: CLSA

Hartalega (upgrade from O-PF to BUY)

Figure 8

Hartalega target price implied multiple

Target price (RM)	6.00
FY20CL EPS (RM)	0.18
Implied Multiple	34.0

Source: CLSA

Figure 9

Hartalega: 5-year forward PE

Source: CLSA

Kossan (upgrade from SELL to BUY)

Figure 10

Kossan PE-derived target price

19CL net income (RMm)	232
Share out (m)	1279
12 mnth fwd 19CL EPS	0.18
Target Multiple	26.7
Target price	4.85

Source: CLSA

Figure 11

Kossan: 5-year forward PE

Source: CLSA

Top Glove (upgrade from U-PF to O-PF)

Figure 12

Top Glove PE-derived target price

CY20 net income (RMm, annualised)	564.3
Net savings (RMm)	8.1
Total	572.5
Shares out (m)	2,527
Bond conversion	131
Diluted share base	2,658
Diluted FY20 EPS (RM, annualised)	0.215
Target PE (x)	25.0
Target price (RM)	5.40

Source: CLSA

Figure 13

Top Glove: 5-year forward PE

Source: CLSA

Valuation details - Hartalega Holdings Bhd HART MK

We value the company based on a discounted cashflow methodology (DCF) using a WACC of 7.9% (COE assumptions: risk-free rate of 4.2%, equity risk premium of 6.7% and one-year observable beta of 0.8x). Our DCF-derived RM5.60 price target implies a 32.1x FY21CL EPS. Continued expansion and operational improvements are the prime drivers for the company's 3-year growth trajectory.

Investment risks - Hartalega Holdings Bhd HART MK

Capacity additions at Hartalega's new Next Generation Complex (NGC), which will triple its production capabilities over the next eight years, started being

commissioned in early 2015. Other glove makers are also aggressively adding nitrile capacity, which could lead to intensified competition in the nitrile segment and squeeze margins. Regulatory tariff hikes could see cost escalating. On supply/demand dynamics, an oversupply could diminish the cost through mechanism, leading to earnings downside risk.

Valuation details - Kossan Rubber Industries Bhd KRI MK

Our valuation methodology is based on ascribing an 21.8x PE multiple to our CY20CL EPS.

Investment risks - Kossan Rubber Industries Bhd KRI MK

Potential cost pressures, such as an increase in wages and fuel prices, would elevate the cost of operations. On the demand side, Kossan's customers are medical distributors which tend to accumulate inventory in periods of low ASPs. Any destocking owing to oversupply could adversely affect the company's volume growth. Concerns have recently been raised about the market supply-demand dynamics as other manufacturers have added significant production capacity in the nitrile segment and this is impacting volume growth at some of the bigger manufacturers.

Valuation details - Top Glove Corp Bhd TOPG MK

Our valuation methodology is based on ascribing a 23.6x PE multiple to our CY20CL earnings.

Investment risks - Top Glove Corp Bhd TOPG MK

A spike in the price of rubber would be a key risk as it comprises 55-60% of the company's operating costs. There are also other potential cost pressures such as wages (rise in minimum wage) and fuel (hikes due to a cut in government subsidies). On the demand side, Top Glove's customers are medical distributors which tend to accumulate inventory in periods of low ASPs; thus any destocking due to oversupply could adversely affect the company's volume growth. Sector demand has switched to nitrile gloves and Top Glove has low exposure to nitrile. Upside risks include an easing competitive environment that alleviates ASP pressure and weakening of the ringgit which could benefit earnings.



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Companies mentioned

Hartalega (HART MK - RM4.83 - BUY)

Kossan Rubber (KRI MK - RM3.66 - BUY)

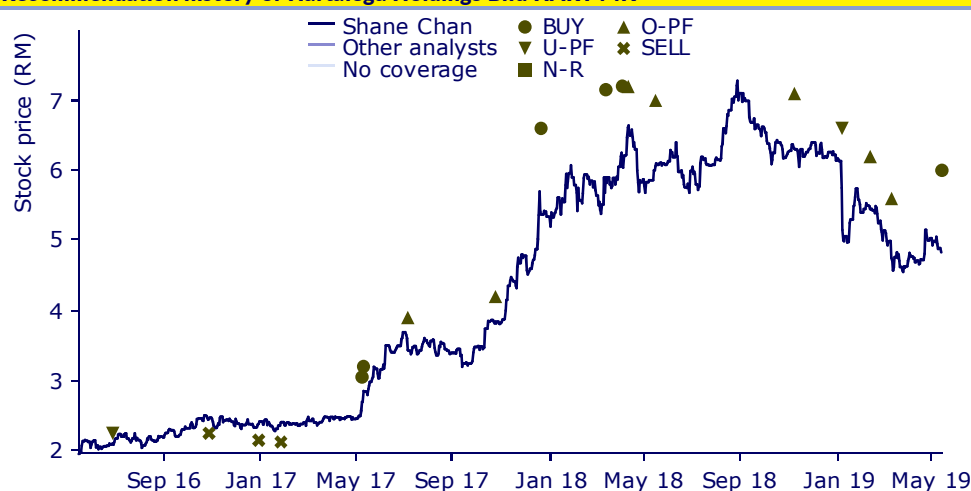
Top Glove (TOPG MK - RM4.67 - O-PF)

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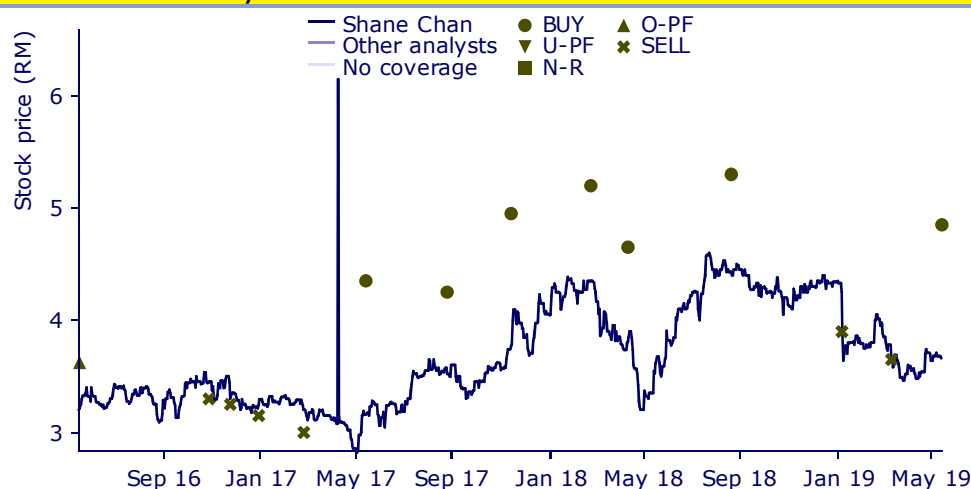
Recommendation history of Hartalega Holdings Bhd HART MK



Date	Rec	Target	Date	Rec	Target
LATEST	BUY	6.00	22 Dec 2017	BUY	6.60*
11 Mar 2019	O-PF	5.60	25 Oct 2017	O-PF	4.20*
12 Feb 2019	O-PF	6.20	06 Jul 2017	O-PF	3.90*
07 Jan 2019	U-PF	6.60	11 May 2017	BUY	3.20*
08 Nov 2018	O-PF	7.10	09 May 2017	BUY	3.05*
16 May 2018	O-PF	7.00	26 Jan 2017	SELL	2.13*
11 Apr 2018	O-PF	7.20	29 Dec 2016	SELL	2.15*
04 Apr 2018	BUY	7.20	27 Oct 2016	SELL	2.25*
14 Mar 2018	BUY	7.15*	27 Jun 2016	U-PF	2.25*

Source: CLSA; * Adjusted for corporate action

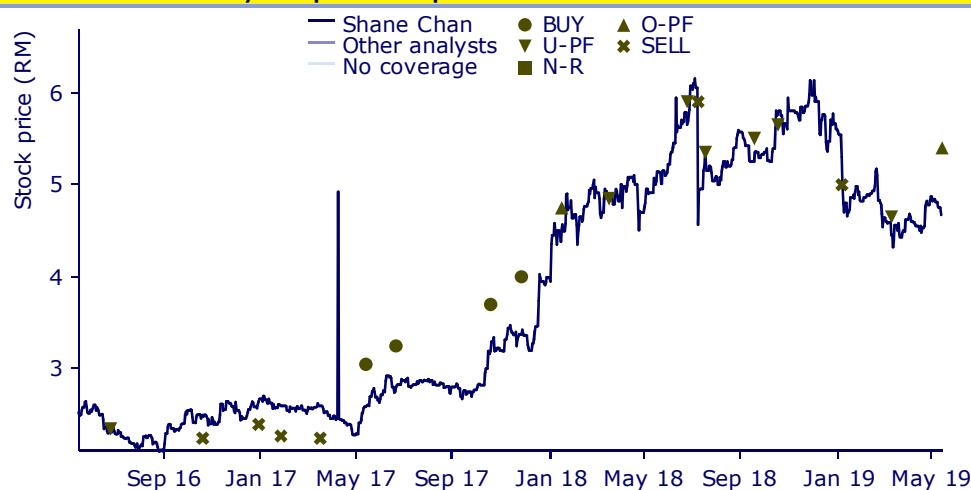
Recommendation history of Kossan Rubber Industries Bhd KRI MK



Date	Rec	Target	Date	Rec	Target
LATEST	BUY	4.85	25 Aug 2017	BUY	4.25*
11 Mar 2019	SELL	3.65	14 May 2017	BUY	4.35*
07 Jan 2019	SELL	3.90	24 Feb 2017	SELL	3.00*
20 Aug 2018	BUY	5.30	29 Dec 2016	SELL	3.15*
11 Apr 2018	BUY	4.65*	23 Nov 2016	SELL	3.25*
23 Feb 2018	BUY	5.20*	27 Oct 2016	SELL	3.30*
14 Nov 2017	BUY	4.95*	16 May 2016	O-PF	3.62*

Source: CLSA; * Adjusted for corporate action

Recommendation history of Top Glove Corp Bhd TOPG MK



Date	Rec	Target	Date	Rec	Target
LATEST	O-PF	5.40	27 Nov 2017	BUY	4.00*
11 Mar 2019	U-PF	4.65	19 Oct 2017	BUY	3.70*
07 Jan 2019	SELL	5.00	21 Jun 2017	BUY	3.25*
18 Oct 2018	U-PF	5.65*	14 May 2017	BUY	3.05*
18 Sep 2018	U-PF	5.50*	17 Mar 2017	SELL	2.25*
18 Jul 2018	U-PF	5.35*	26 Jan 2017	SELL	2.28*
09 Jul 2018	SELL	5.90*	29 Dec 2016	SELL	2.40*
25 Jun 2018	U-PF	5.90*	19 Oct 2016	SELL	2.25*
18 Mar 2018	U-PF	4.85*	24 Jun 2016	U-PF	2.35*
17 Jan 2018	O-PF	4.75*			

Source: CLSA; * Adjusted for corporate action

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Shane Chan assumed coverage of Top Glove on 17 March 2016. Prior to that, the stock was covered by Afiq Mohammad.

Shane Chan assumed coverage of Hartalega on 6 April 2016. Prior to that, the stock was covered by Afiq Mohammad.

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