Rubber Gloves

Ready To Bounce

OVERWEIGHT
↑

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We upgrade our sector rating from NEUTRAL to 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, (iii) weakening of the MYR against the USD. Rubber glove stocks are presently trading at more palatable valuations following retracement in YTD 2019 share prices of rubber glove stocks under our coverage led by HARTA (-15%), TOPGLOV (-14%), KOSSAN (-9%) and SUPERMX (-5%). Based on current valuations, we believe all the negatives are largely priced in, rubber gloves stocks are now trading between slightly above mean, which appears undemanding. We have OUTPERFORM calls on HART (OP; TP: RM5.85); and KOSSAN (OP; TP: RM5.25). 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 its peers in terms of better margins and reduction in costs, (ii) constantly evolving via innovative products development, and (iii) its nitrile gloves segment, which is booming.

Lofty valuations back down to earth. Rubber glove stocks under our coverage have depreciated YTD led by HARTA (-15%%), TOPGLOV (-14%), KOSSAN (-9%) and SUPERMX (-5%), in line with normalizing demand, swelling capacities and intensified competition, which are pointing towards potentially slower subsequent quarters. We believe all the negatives could have been priced in with valuations trading at more palatable PERs of between mean and +1.0SD five-year forward average which appears undemanding. We are not perturbed and expect stock prices to Outperform again in subsequent quarters. 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, (iii) weakening of the MYR against the USD.

Oversupply concerns overplayed. 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.

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 has 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 impact of competition were; (i) slowed 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. Having experienced various cycles of oversupply, we believe players are now better at responding to competitive pressures. We see the ASPs pressure problem in the sector fully sorting itself out within another quarter. Recall, while pricing adjustments were made, there was a time lag of two months before the cost increase could be shared out with customers.

Upgrade from NEUTRAL to 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, (iii) weakening of the MYR against the USD. Based on current valuations, we believe all the negatives are largely priced in, gloves stocks are now trading slightly above their respective mean, which appears undemanding.

Our Top Pick in the sector is HARTALEGA. 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 its peers in terms of better margins and reduction in costs, (ii) constantly evolving via innovative products development, and (iii) its nitrile gloves segment, which is booming. Our TP is RM5.85 based on unchanged 36x CY20 EPS (at +1.0SD above 5-year historical forward mean).

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 12%. Our TP is RM5.25 based on 25.5x FY20E EPS (+1.0SD above 5-year historical forward mean).

KEY POINTS

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 rubber gloves under 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 is scaling back and 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 accounts for an estimated average 75% of 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.

Estimated incoming capacity indicating equilibrium supply-demand of rubber gloves

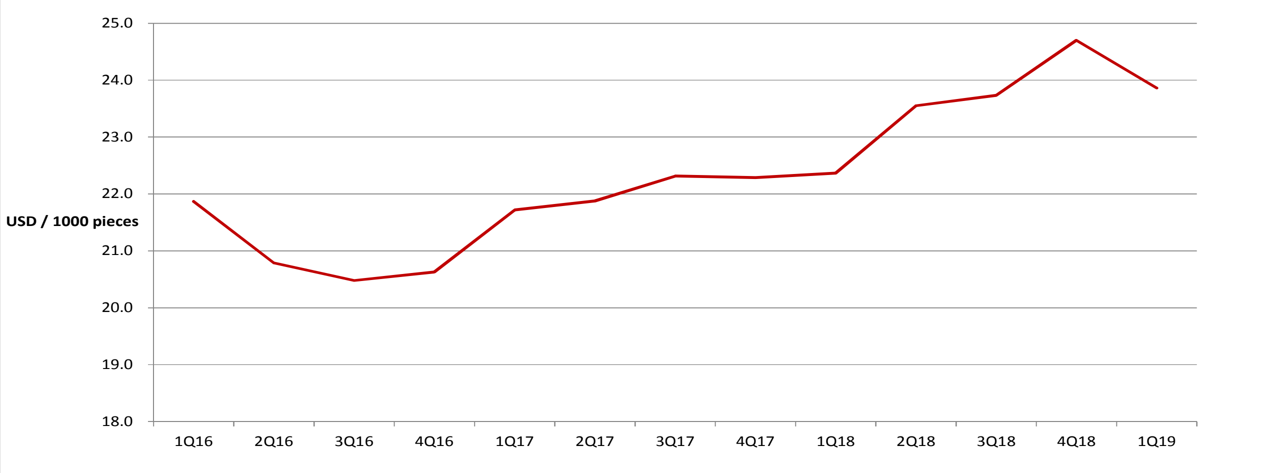
	Top Glove	Supermax	Kossan	Hartalega	Total
Estimated capacity in end CY2018 (bn pieces)	60.5	23.9	26.5	31.2	142.1
Estimated new capacity	2.6^	2.0	3.0	4.0	11.6
Total estimated capacity by end CY2019	63.1	26.9	29.5	36.0	153.7
	Top Glove	Supermax	Kossan	Hartalega	Total
Estimated capacity in end CY2019 (bn 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 has 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) slowed 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.

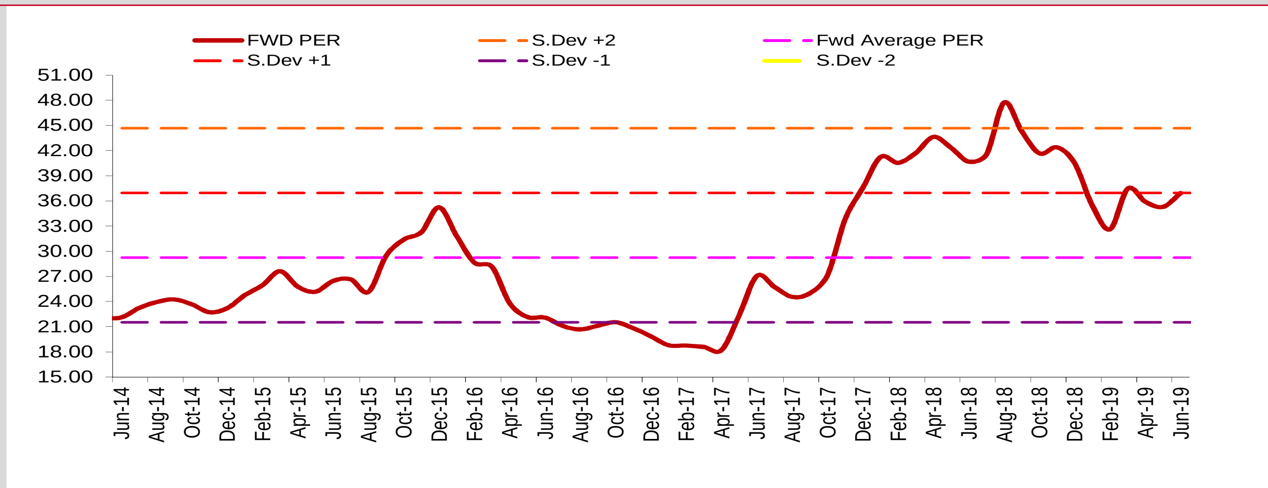
Rubber Gloves ASPs/1000 pieces – stable



Source : Industry, Kenanga Research

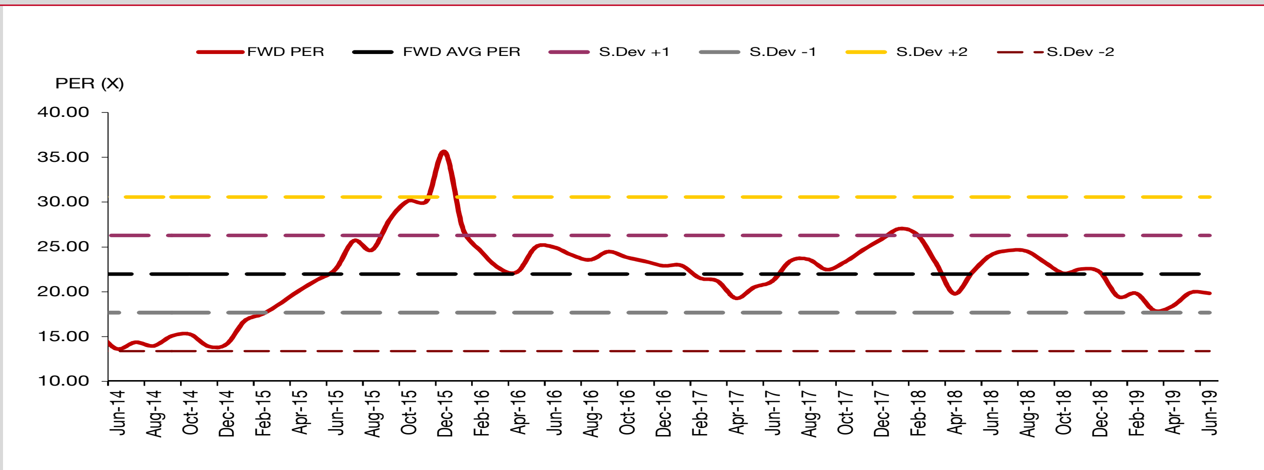
Valuations appear palatable. Rubber glove stocks under our coverage have depreciated between 5-15% YTD led by HARTA (-15%%), TOPGLOV (-14%%), KOSSAN (-9%) and Supermax (-5%), in line with normalizing demand, swelling capacities and intensified competition, which are pointing towards potentially slower subsequent quarters. We believe all the negatives could have been priced in with valuations trading at more palatable PERs of between mean and +1.0SD five-year forward average which appears undemanding. We are not perturbed and expect stock prices to Outperform again in subsequent quarters. The optimism is based on our analysis that the slower-than-expected new capacity expansion should help keep supply-demand in equilibrium and ultimately dispel market scepticism of an oversupply situation.

Harta - Forward PER



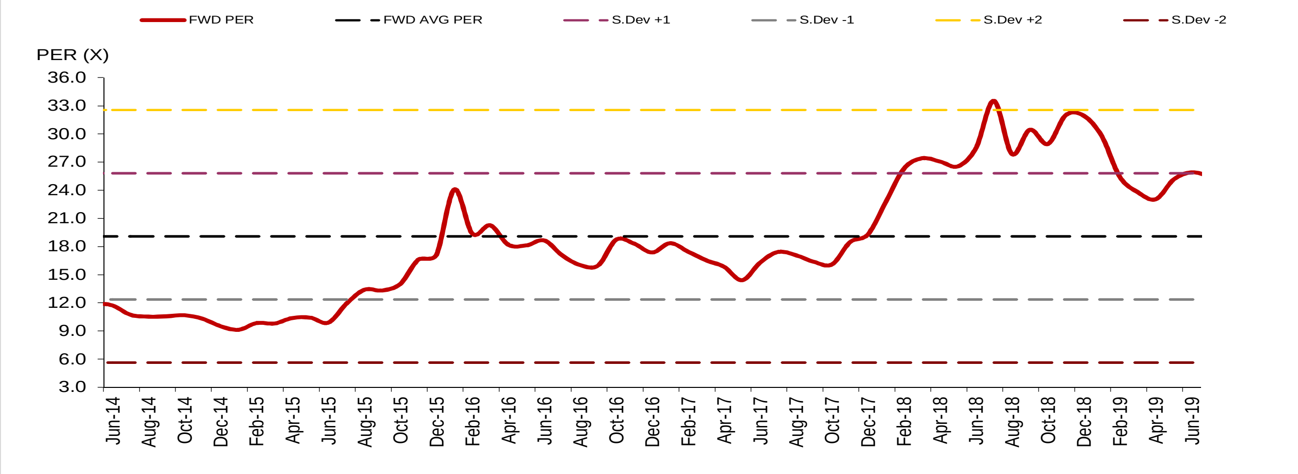
Source : Bloomberg, Kenanga Research

Kossan - Forward PER



Source : Bloomberg, Kenanga Research

Topglov - Forward PER



Source : Bloomberg, Kenanga Research

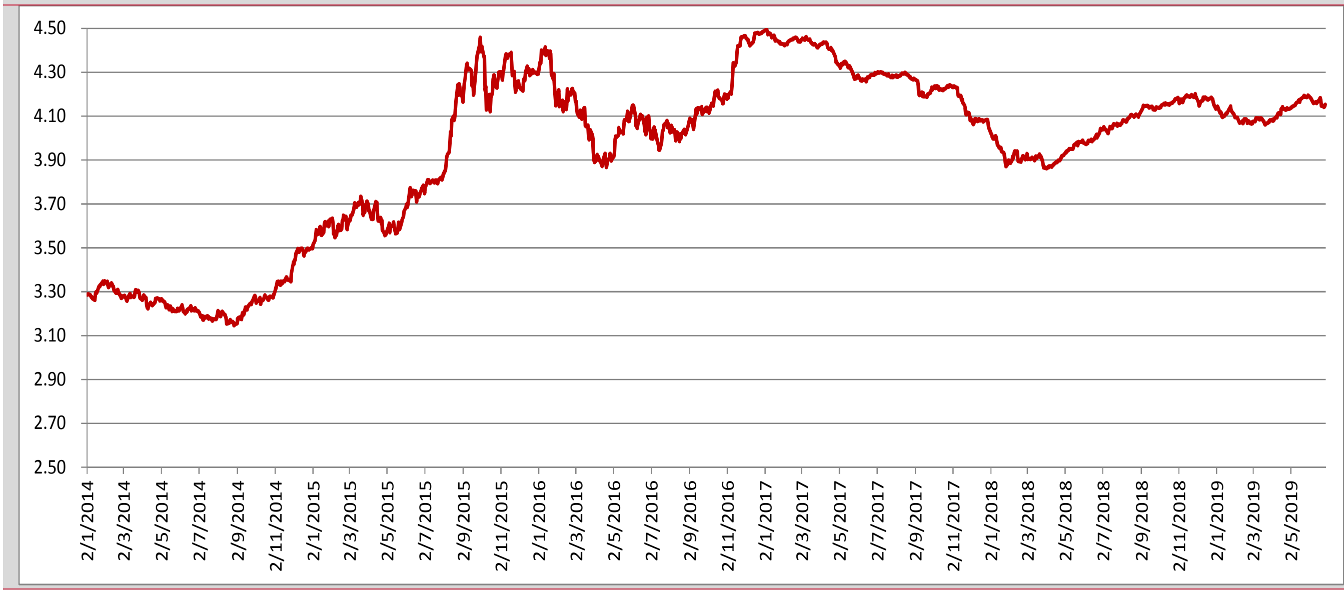
Expecting raw material inputs to trade lower or maintain current price levels going forward. Latex price appears to trend upwards during the seasonal wintering months starting end-Dec till May (please see chart below). In anticipation of shortage in latex production supply during the wintering months, latex price has risen 33% to RM5.04kg 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 years 2019 and 2020. Similarly, consumption in China, which accounts for an estimated 40% of world consumption, is anticipated to take a slow 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

Weakening of Ringgit (RM) vs. US dollar (USD) is short-term positive to rubber glove players. Generally, a weakening Ringgit is positive for glove makers. Since sales are USD denominated, theoretically, a depreciating ringgit against the dollar will lead to more revenue receipts for glove makers. Ceteris paribus, a 1% depreciation of RM against USD will lead to an average 1%-2% increase in the net profit of rubber glove players. However, we believe the impact from currency movements (MYR vs USD) to glove players' earning is neutral over the long-term. This is because glove players typically hedge the currency on a consistent basis, hence in theory any negative or positive impact will be offset over time.

USD vs MYR



Source: Bloomberg, Kenanga Research

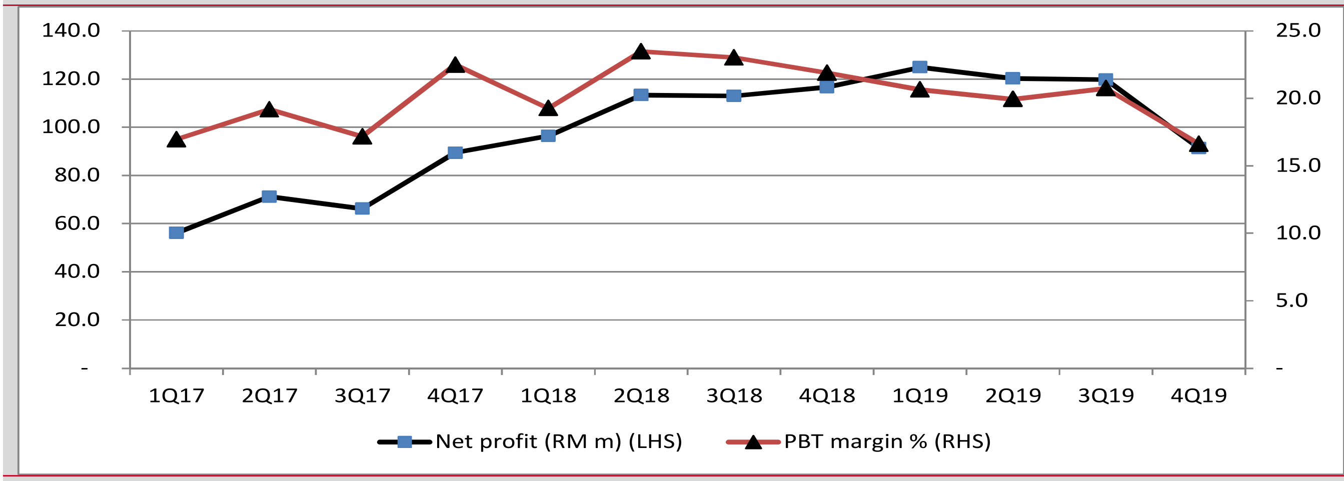
Net profit sensitivity based on USDMYR and volume sales

	assuming RM appreciate 1% against USD		assuming volume increase 1%	
	Impact to FY19E net profit	Impact to FY20E net profit	Impact to FY19E net profit	Impact to FY20E net profit
Kossan	-1.0%	-1.0%	+1.0%	+1.0%
Top Glove	-1.1%	-1.9%	+1.1%	+1.9%
Hartalega	-1.2%	-1.2%	+1.2%	+1.2%
Supermax	-1.2%	-1.3%	+1.2%	+1.3%

Source: Companies, Kenanga Research

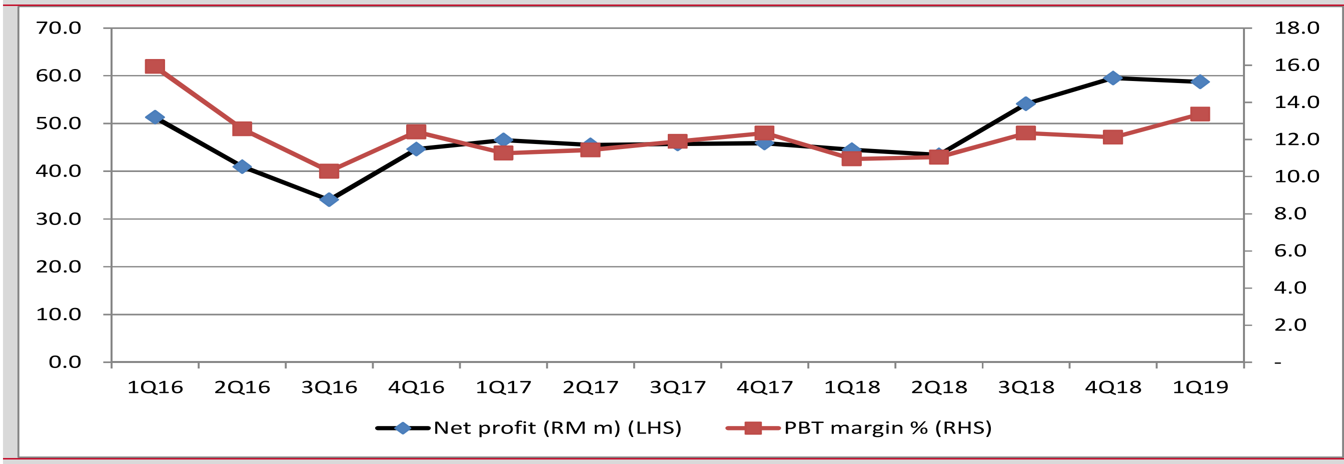
1QCY19 results potentially probably the worst quarter. The just-concluded 1QCY19 results of glove makers under our coverage came in within expectations. 1QCY19 results were largely plagued by short-term oversupply, intense competition and ASPs pressure. All players suffered lower sequential volume sales (-3-5%) and ASPs (-5-7%). The star performer was Kossan, which recorded a 32% YoY net profit growth underpin by new capacity expansion in plant 16 and 17. However, Hartalega's 4Q19 result was hit by lower volume sales and APS pressure due to intense competition. Top Glove suffered its lowest quarter since 1Q17 due to a mismatch between higher latex price (+22%) and ASPs, competitive pressure and time lag in passing cost through. Supermax's 1H19 results continued to remain solid on volume growth from new capacity in plant 16 and 17.

Hartalega quarterly net profit and PBT margin trend : indicating probably the worst quarter



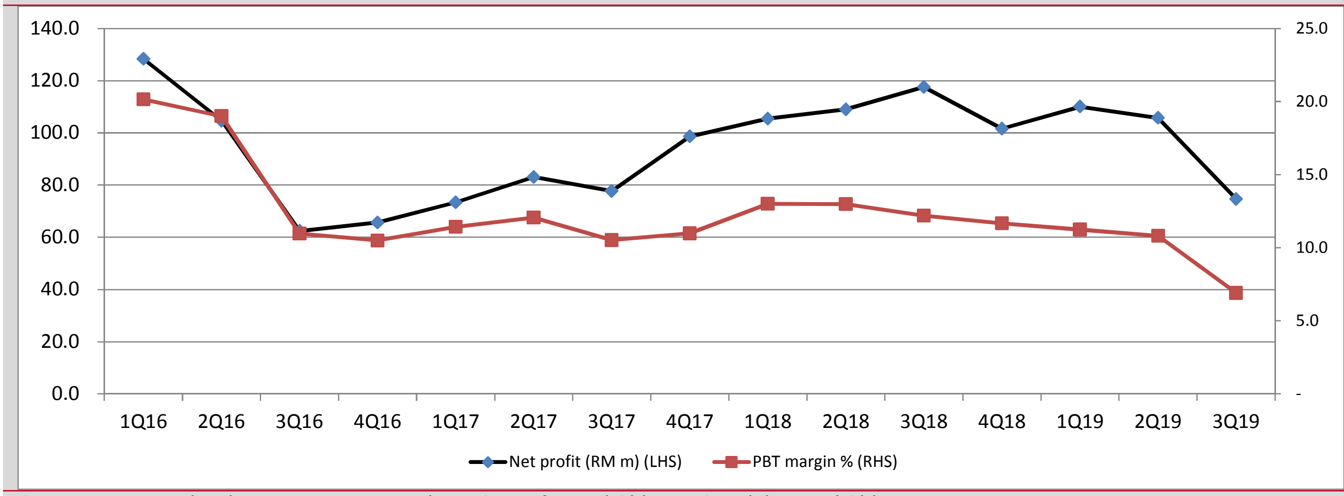
Source: Bursa Malaysia, Kenanga Research; LHS – Left Hand Side; RHS –Right Hand Side

Kossan net profit and PBT margin trend : On uptrend due to low base effect and new capacity



Source: Bursa Malaysia, Kenanga Research; LHS – Left Hand Side; RHS –Right Hand Side

Top Glove quarterly net profit and PBT margin trend : indicating probably the worst 3Q19 quarter



Source: Bursa Malaysia, Kenanga Research; LHS – Left Hand Side; RHS –Right Hand Side

Our Top Pick in the sector is HARTALEGA. We like Hartalega because: (i) its “highly automated production processes” model is moving from ‘good’ to ‘great’ as they are head and shoulders above its peers in terms of better margins, solid improvement in production capacity and reduction in costs; (ii) offers superior quality nitrile gloves through product innovation; and (iii) nitrile gloves segment is booming.

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 12%.

Upgrade Supermax TP, reiterate MP. We raised Supermax TP from RM1.50 to RM1.70 based on higher 17.5x FY20E PER (compared to 15.5x previously at +0.5 SD above its historical forward average). We raise our PER from 15.5x to 17x which is inline our target valuation of +1.0 SD above 5-year forward average for peers. The group is trading at a discount of 30% compared to the sector’s average due to its weak earnings guidance and it trailing behind peers in terms of capacity expansion and innovation.

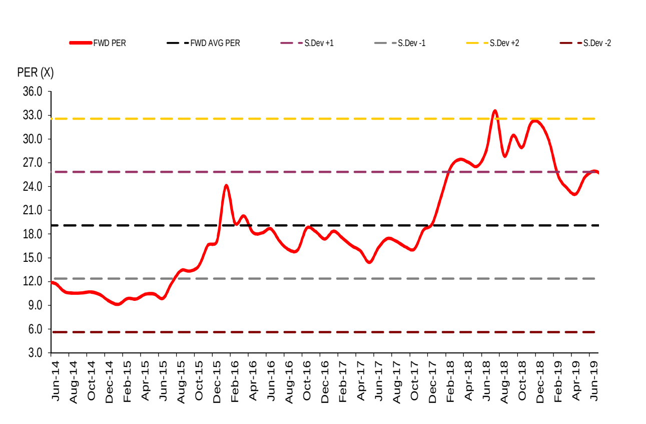
Upgrade from NEUTRAL to OVERWEIGHT. Our investment case is based on: (i) our analysis that the new capacity expansion is slower-than-expected, which should help maintain the supply-demand equilibrium, (ii) earnings growth to resume in subsequent quarters, boosted by higher ASPs, (iii) weakening of the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

Rubber Gloves

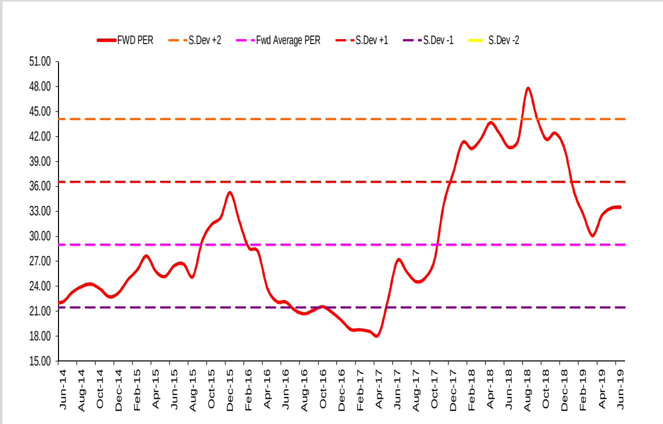
Company	Target Price (RM)	Valuation basis
Kossan Rubber	5.25	based on 25.5x FY20E EPS (+1.0SD above 5-year historical forward mean)
Hartalega	5.85	based on 36x CY20 EPS (at +1.0SD above 5-year historical forward mean)
Top Glove	4.70	based on 25.5x FY20E EPS (+1.0SD above 5-year historical forward mean)
Supermax	1.70	based on 17.5x FY20E EPS (at +1.0SD above its historical forward mean)

Source: Companies, Kenanga Research

Top Glove - Forward PER

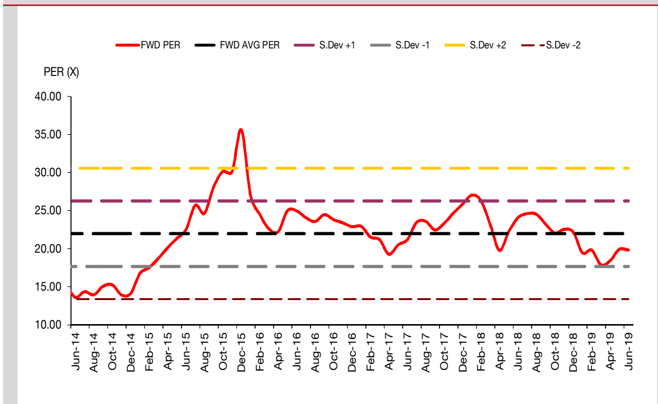


Hartalega - Forward PER

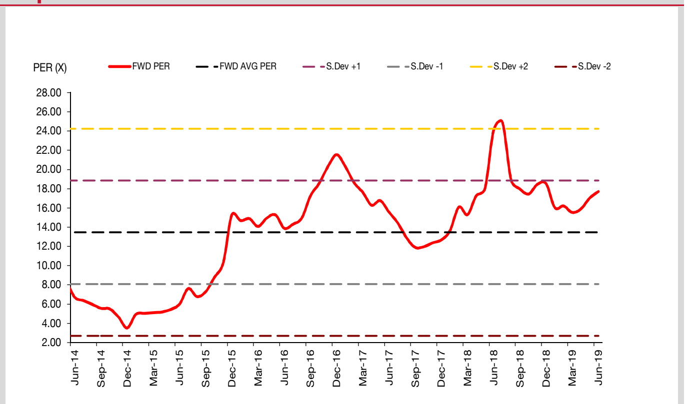


Source: Bloomberg, Kenanga Research

Kossan - Forward PER



Supermax - Forward PER



Source: Bloomberg, Kenanga Research

Peer Comparison

Name	Price @ 21/6/19 (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth 1-Yr. Fwd.	Revenue Growth 2-Yr. Fwd.	Core Earnings Growth 1-Yr. Fwd.	Core Earnings Growth 2-Yr. Fwd.	PER (x) - Core Earnings Hist.	PER (x) - Core Earnings 1-Yr. Fwd.	PER (x) - Core Earnings 2-Yr. Fwd.	PBV (x) Hist.	PBV (x) 1-Yr. Fwd.	ROE (%) 1-Yr. Fwd.	Net Div Yld (%) 1-Yr. Fwd.	Target Price (RM)	Rating
RUBBER GLOVES																	
HARTALEGA HOLDINGS BHD	5.25	17567.4	Y	03/2020	3.7	6.2	11.6	6.7	38.0	34.0	31.9	7.7	6.9	20.3	1.3	5.85	OP
KOSSAN RUBBER INDUSTRIES	3.96	5064.6	Y	12/2019	8.4	4.4	23.7	6.0	25.2	20.4	19.2	3.8	3.4	16.7	1.5	5.25	OP
SUPERMAX CORP BHD	1.69	2208.0	Y	06/2019	11.9	4.9	19.1	4.0	21.5	18.0	17.3	2.2	2.1	11.4	2.4	1.70	MP
TOP GLOVE CORP BHD	5.00	12809.6	Y	08/2019	4.5	4.6	-5.2	13.8	29.4	31.0	27.2	5.3	4.9	15.8	1.7	4.70	MP

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.***

Published and printed by:

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