Hartalega Holdings Berhad

(5168 | HART MK) Health Care| Health Care Equipment & Services

Overstretched valuation

***Downgrade to* SELL**

(Previously Neutral)

***Unchanged Target* Price: RM4.90**

KEY INVESTMENT HIGHLIGHTS

- **3QFY20 earnings came in at RM121.3m, in line with our expectation**
- **Average selling price contracted further as competition in nitrile glove segment intensifies**
- **Consequently, the higher operating costs were unable to be fully passed on to customers in order to protect market share.**
- **Current valuation is justified given the subdued performance**
- **Downgrade to SELL with an unchanged TP of RM4.90**

Earnings met our expectation. Hartalega Holdings Berhad's (Hartalega) 3QFY20 earnings came in at RM121.3m. This brings its cumulative 9MFY20 earnings to RM319.3m which met ours but lagged consensus' full-year FY20 earnings estimates at 72.2% and 66.4% respectively. Comparing on a year-on-year basis, 3QFY20 revenue staged a commendable improvement in revenue of +10.1%yoy driven by a higher sales volume. Nonetheless, improvement in earnings was only marginal at +1.3%yoy due to the higher operating expenses.

Continue decline in average selling price. During the quarter-in-review, sales volume grew by +17.4%yoy to 8.5b pieces attributable to the: (i) fully commissioning of Plant 5 and; (ii) higher overall plan utilisation rate at 96.0% (vs Q3FY19: 87.8%). However, the higher sales volume was mitigated by the decline in average selling price (ASP) by -6.2%yoy to about RM94.1 per thousand pieces. The contraction in ASP was caused by the downward pricing pressure from the aggressive expansion of nitrile glove manufacturing capacity by fellow competitors.

Shrinking profit margin. Consequently, the higher operating costs were unable to be fully passed on to customers in order to protect market share. Note that the increase in 3QFY20 operating expense had outpaced the quarter revenue growth (+12.2%yoy against +10.1%yoy) due to higher overhead costs. In addition, effective tax rate rose by +3.4ppts to 23.8%. This was due to the higher deferred tax expense arising from the ongoing construction of Plant 6 and Plant 7. This resulted in a marginal improvement in 3QFY20 earnings.

Expect muted earnings impact from nCoV19 outbreak. The novel coronavirus (nCoV19) outbreak has triggered higher hygiene awareness globally which in turn spurred an increase in demand for gloves in the near term at least. Nevertheless, we do not think Hartalega is the main beneficiary from this outbreak. This is due to its existing plants currently operating at near to full utilisation rate i.e. 96.0% while Plant 6 has only commenced two lines as of mid-February 2020. Hence, this limits its ability to cater the sudden spike in demand. In addition, Plant 7 which is expected to be commissioned by the end of CY20 caters for made-to-order speciality gloves.

RETURN STATISTICS	
Price @ 11th February 2020	6.00
Expected share price return (%)	-18.3
Expected dividend yield (%)	+1.6
Expected total return (%)	**-16.7**

SHARE PRICE CHART

Share price performance (%)	Absolute	Relative
1 month	+10.5	+13.3
3 months	+9.5	+18.6
12 months	+10.1	+19.7

KEY STATISTICS	
FBM KLCI	1,551.48
Syariah compliant	Yes
Issue shares (m)	3,345.19
Estimated free float (%)	37.99
Market Capitalisation (RM'm)	20,276.91
52-wk price range	RM4.52 – RM6.44
Beta vs FBM KLCI (x)	0.80
Monthly velocity (%)	11.02
Monthly volatility (%)	15.48
3-mth average daily volume (m)	4.14
3-mth average daily value (RM'm)	23.67
Top Shareholders (%)	
Lim Wee Chai	47.89
EPF	2.98
KWAP	1.75

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Second interim dividend declared. Hartalega declared its second interim dividend for FY20 of 1.8sen per share (vs 3QFY19 of 2.2sen). Cumulatively, dividend declared as of 9MFY20 was within our expectation at 3.6sen (vs 9MFY19 of 4.4sen).

Impact to earnings. We are maintaining our forecasts at this juncture as our estimates are still within expectation.

Target price. We are maintaining our target price at **RM4.90** per share. This is derived via pegging our FY21F EPS of 15.8sen to PER21 of 31.0x, which is -1.5SD below its three-year average historical PER. We prescribed a discount to Hartalega's historical PER valuation in light of the diminishing differential between its profit margins in comparison to its peers.

Downgrade to Sell. We remain concern on the ASP contraction in view of the intensifying competition in the nitrile glove segment. The recent restoration of the supply-demand dynamic came at cost of lower ASP despite the picked-up in sales volume. In the near term, we believe that higher sales volume resulting from capacity expansion will sustain earning growth. Note that annual capacity will increase from approximately 37.3b pieces to 44.7b pieces by FY22 (+19.8%). Valuation wise, the stock is currently trading close to PER of 44.0x which is +1.0SD above its three-year average historical PER. We do not believe that current valuation is justified given the recent subdued performance. In addition, we do not believe that the nCoV19 outbreak will significantly lift group's future earnings. Hence, investors could take profit from the recent share price spike which we believe are not fully backed by fundamentals. All things considered, we are downgrading our stock recommendation to **SELL** (previously Neutral) on Hartalega.

INVESTMENT STATISTICS

Financial year ending 31st March (in RM'm, unless otherwise stated)	FY2018	FY2019	FY2020E	FY2021F	F2022F
Revenue	**2,405.6**	**2,827.9**	**3,092.0**	**3,641.1**	**3,903.3**
Cost of goods sold	(1,917.4)	(2,266.1)	(2,293.0)	(2,292.0)	(3,153.8)
Gross profit	**488.2**	**561.7**	**556.6**	**673.6**	**749.4**
Finance costs	(7.9)	(9.9)	(10.8)	(12.7)	(15.6)
Profit before tax	**526.8**	**551.9**	**545.8**	**660.9**	**733.8**
Income tax expense	(86.6)	(95.6)	(103.7)	(119.0)	(146.8)
PATANCI	**440.2**	**456.2**	**442.1**	**541.9**	**587.1**
PATANCI margin (%)	18.3	16.1	14.3	14.9	15.0
EPS (sen)	12.8	13.7	12.9	15.8	17.1
EPS Growth (%)	55.5	7.0	(6.2)	22.6	8.3
PER (x)	46.7	36.8	46.5	38.0	35.1
Dividend Per Share (sen)	5.9	8.2	7.7	9.5	10.3
Dividend yield (%)	1.0	1.2	1.3	1.6	1.7

Source: Company, MIDFR

Table 1: Hartalega's quarterly earnings review

FYE Mar (RM'm)	Quarterly results					Cumulative results		
	3QFY20	**2QFY20**	**3QFY19**	**YoY (%)**	**QoQ (%)**	**9MFY20**	**9MFY19**	**YoY (%)**
Revenue	796.6	709.4	723.4	10.1	12.3	2,146.1	2,144.0	0.1
Operating expenses	(642.3)	(566.7)	(572.3)	12.2	13.3	(1,724.6)	(1,681.8)	2.5
Other operating income	7.8	(2.4)	1.6	375.3	(426.4)	5.8	(16.3)	nm
Finance costs	(2.4)	(3.0)	(2.8)	(12.8)	(19.4)	(8.7)	(7.7)	12.5
Profit Before Tax	**159.7**	**137.3**	**150.0**	6.5	16.3	**418.7**	**438.2**	(4.5)
Taxation	(38.0)	(33.1)	(30.7)	24.0	14.8	(98.6)	(73.4)	34.3
Profit After Tax	**121.7**	**104.2**	**119.3**	1.9	16.8	**320.1**	**364.8**	(12.2)
Non-controlling interest	0.3	0.3	(0.4)	(180.7)	-	0.9	-	nm
PATANCI	**121.3**	**103.9**	**119.8**	1.3	16.8	**319.3**	**364.8**	(12.5)
Basic EPS (sen)	3.6	3.1	3.6	-	16.5	9.5	11.0	(13.6)
Diluted EPS (sen)	3.6	3.1	3.5	1.1	17.0	9.4	10.8	(12.9)
PBT margin (%)	20.0	19.4	20.7	(3.3)	3.6	19.5	20.4	(0.9)
PAT margin (%)	15.3	14.7	16.5	(7.4)	4.0	14.9	17.0	(2.1)
PATANCI margin (%)	15.2	14.6	16.6	(8.0)	4.0	14.9	17.0	(2.1)
Effective Tax Rate (%)	23.8	24.1	20.4	16.5	(1.2)	23.5	16.7	6.8

Source: Company, MIDFR

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.