06 November 2015 | Initiate Coverage

Supermax Corporation Berhad

OBM expenses pressuring on profit margin

Initiate with NEUTRAL

Target Price (TP): RM2.09

INVESTMENT HIGHLIGHTS

- **Pioneer of OBM gloves in Malaysia**
- **Wide export market to over 155 countries**
- **Completion of Plants 10 and 11 to increase capacity by 30%**
- **Stock currently trading at a comparatively low PER of 14x**
- **Initiate Supermax with a NEUTRAL stance at TP of RM2.09 per share based on PER16 of 14x**

Own Brand Manufacturer (OBM) pioneer. Supermax is a leading glove manufacturing company, producing both latex and nitrile gloves. It was founded in 1987 as a trading business distributing latex gloves. In 1989, Supermax commenced production of its first glove manufacturing facility and launched its first OBM under the brand name Supermax. Since then, it is now operating nine manufacturing plants and has a market capital of more than RM1.4b.

Capacity expansion - slowly but surely. Supermax's manufacturing plants based in Malaysia are equipped with energy-saving biomass systems and a research and development centre. It also has distribution offices in various countries, namely USA, Brazil, Canada, Germany, Belgium, United Kingdom and 750 other independent distributors around the world. Its current total glove capacity is approximately 18b pieces per annum.

By end-2015, Supermax expects to complete the expansion of its plant 10 and 11 which will translate into a total capacity of 24.96b pieces of gloves per annum. Although the expansions of these two plants have been delayed due to various external factors, we believe that the management will most probably complete the expansions by 2016. The expansion plans for Supermax can be found in Table 1.

Wide export market. By having distribution centres in various countries, Supermax is able to market its products efficiently in the overseas market. Currently, the group exports to 1,205 customers in over 155 countries. Its main export markets are North America and Europe which contribute 40% and 26% respectively to its sales. Other regions include South America (15%), Asia (8%), Africa/Middle east (7%) and Central America (4%). The group has also stated that it plans to expand its export market to Russia and Mexico. The group has also deemed China, India and the United Arab Emirates as potential countries to expand its overseas distribution centres.

RETURN STATS	
Price (05 November 2015)	RM2.23
Target Price	RM2.09
Expected Share Price Return	-6.3%
Expected Dividend Yield	+3.0%
Expected Total Return	**-3.3%**

STOCK INFO	
KLCI	1,688.54
Bursa / Bloomberg	7106 / SUCB MK
Board / Sector	Main / Industrial Products
Syariah Compliant	YES
Issued shares (mil)	671.3
Par Value (RM)	0.50
Market cap. (RM'm)	1,496.9
Price over NA	1.59
52-wk price Range	RM1.58-RM2.67
Beta (against KLCI)	0.82
3-mth Avg Daily Vol	4.12m
3-mth Avg Daily Value	RM9.05m
Major Shareholders (%)	
Kim Sim Thai	20.71
Bee Geok Tan	15.33
FMR LLC	5.13
EPF	5.03

Table 1: Supermax's Expansion Plan

	Location	Land size	Capacity (bn pieces)	Capex (RM)	Projected Time Frame
Bukit Kapar "Glove city"	Bukit Kapar, Selangor	36 acres	24.6	550m	10-12 years
Supermax Business Park ("Integrated Glove Manufacturing Centre")	Serendah, Selangor	60 acres (60% of land bank)	15.5	750m	9 years
Supermax Business Park (supporting industries)	Serendah, Selangor	40 acres	-	400m	3-5 years

Source: Company, MIDFR

FINANCIAL HIGHLIGHTS

Marginal revenue growth. From 2011-2014, the cumulative annual growth rate (CAGR) of its revenue showed a decline of -4.9%. This decline was attributable to the lower average selling prices (ASP) of gloves, although the sales volume continued to record growth. The lower ASP of gloves was due to the depressed raw material prices. From 2011-2014, the average price of natural rubber latex fell by more than -50% to RM4.5 per kilogram. As for synthetic latex, the price declined by -40% to USD1,055 per tonne during the same period. However, from 2011-2014, the ASP for gloves declined at a smaller percentage of -33.7% for natural rubber gloves and -17.1% for nitrile gloves. Currently, the price of natural rubber latex and synthetic latex are still depressed as the demand lags increasing supply. If this situation remains unchanged, we can expect the ASP of gloves to remain low going forward.

Chart 1: Revenue

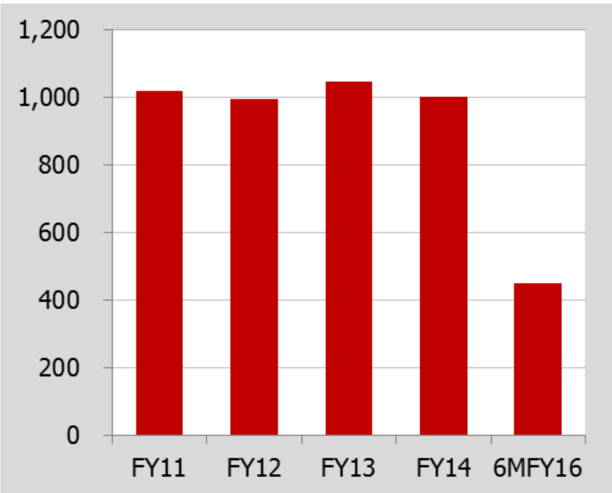
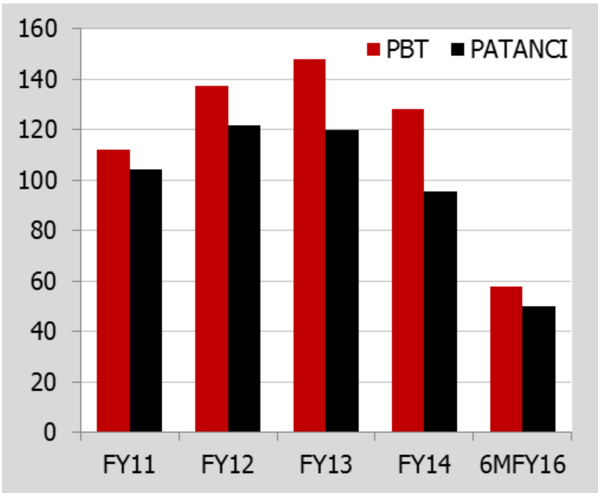


Chart 2: PBT and PATANCI



Source: Company, MIDFR

PBT increased but net profit impacted by higher tax expenses. Supermax's profit before tax (PBT) increased at a CAGR of +49.8% since 2011-2014. This increase was contributed by the lower cost of goods sold which reduced by a CAGR of -40.1%. Despite the positive results for the profit before tax (PBT), the net profit's CAGR declined significantly by -22.6% (2011-2014). The decline was mainly due to the lower tax rate in 2011 of only 7.2%, whereas it incurred a tax rate of 25.8% in 2014. Compared to 2013, the earnings had also declined by -20.1%. This was due to the lower tax rate of 19.7% in 2013. The lower tax rate in 2013 was due: (i) RM1.6b of income not subject to tax; (ii) RM1.7b difference in shares of profits of associates and; and (iii) RM5.6b deferred tax incurred in 2013. Going forward, we expect the lower applicable tax rate of 24% in 2016 to marginally support the future growth in earnings. The group also mentioned that it has unutilised tax losses worth up to RM1.8b (refer to 2014 Annual report).

Expecting lower margins. The four-year historical average profit after tax (PAT) margin is 10%. However, in 2014, the PAT margin fell from the low double digits to high single digits of 9.5%. This was mainly due to the higher staff cost and operating expenses which had caused the gross profit margin to decline by -1.7ppts to 19.1%. The share in profits associates had also reduced by -41.5% in 2014 compared to 2013. Supermax's associates consist of its distribution offices in Brazil, Belgium and Canada. Going forward, we expect the Group's PBT margin to remain low at circa 11% and its PAT margin to maintain at levels of 8-9%. The lower margin is due to the expected gradual increase in staff costs in 2016 coupled with the increase in operating expenses.

30% dividend policy. Supermax currently has a dividend policy of 30% of its PAT. The payout ratio was increased to the current level in 2012, from 20% previously. Among its peers, this dividend policy is at par with **Kossan Rubber Industries (NEUTRAL; TP: RM7.84)**, yet lagging behind **Hartalega Holdings (NEUTRAL; TP: RM8.90)** and **Top Glove Holdings (NEUTRAL; TP: RM9.84)** which have dividend payout policies of 45% and 50% respectively.

KEY CHALLENGES

High OBM product mix. Supermax's current Original Equipment Manufacturer (OEM) is only 30.5% of total volume. It has a strong concentration on its OBM products constituting 69.5% of its total product volume. This is higher than the other glove companies which have an OBM segment of less than 30% of total volume. On the surface, OBMs eliminate the company's dependency rate on its bulk customers, but OBMs are also tougher to market, thus increasing its operating expenses.

Low ASP due to raw material price. As aforementioned, the price of natural rubber (NR) latex is currently low, trending at RM4.5 per kilogram. Similarly, synthetic latex (also known as nitrile) prices have also fallen to levels lower than USD1,100 per tonne. These low raw material prices are beneficial to glove manufacturers as it would result in lower operating expenses. However, in the usual course of events, most glove manufacturers would have to reduce their ASPs relative to the fall in raw material price as requested by its customers. Due to this, Supermax would have to increase its sales volume to maintain an adequate amount of revenue growth.

Chart 3: Trend for NR latex vs ASP NR gloves

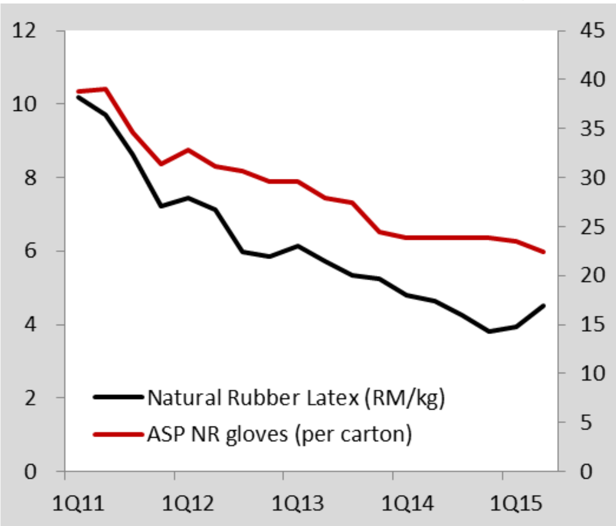
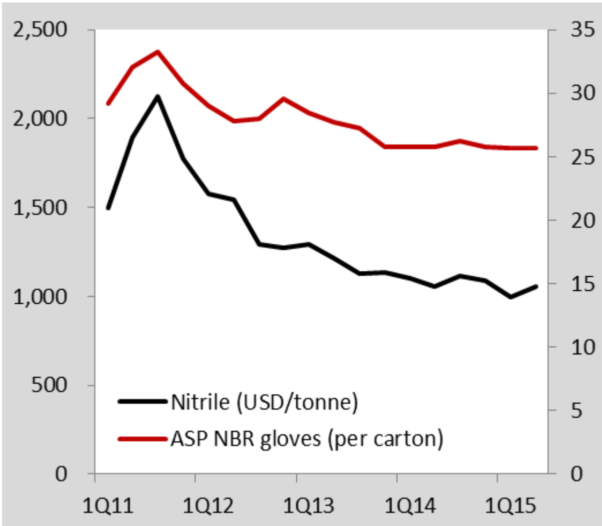


Chart 4: Trend for nitrile vs ASP NBR gloves



Source: Company, MIDFR

Volatility of MYR against USD. Most glove manufacturers in Malaysia export to the rest of the world with the main export market being North America and Europe. The currency used for export is US Dollar while most operating expenses are incurred in Ringgit. This excludes the purchase of nitrile which is traded in US Dollar. This makes glove manufacturers the big beneficiary of strengthening USD/MYR. For Supermax, it produces mostly latex gloves with a production mix of Latex:Nitrile:Surgical gloves at 52:45:3. Going forward, if the Ringgit remains weak, we expect Supermax's revenue growth to be sustainable. However, Supermax risks a slowdown in revenue growth if the Ringgit were to stage a sustainable rebound.

PROSPECTS

Growth from UAE, India and China. Going forward, the group foresees its distribution growth to come from the UAE, India and China. Furthermore, at its existing distribution center in the United Kingdoms (UK), the group is participating directly in the National Healthcare Services (NHS) UK contract. This contract will enable the group to supply gloves to UK hospitals.

Expect to expand nitrile gloves in the dental market. The group is also targeting to expand its nitrile gloves in the dental market of United States of America (USA). This is in-conjunction with the expansion of the National Distribution Headquarters in USA. Currently, the group's largest target market is the dental & scientific laboratory market which constitutes 47% of the group's production. The remaining 53% consists of medical segment (43%), food & services (4%), industrial (4%), and bio-tech (2%).

VALUATION

Initiate with NEUTRAL at a Target Price (TP) of RM2.09 per share. We initiate coverage on Supermax with a **NEUTRAL** recommendation and target price of **RM2.09** per share. Our valuation is based on PER16 of 14x pegged to the group's forecasted annualised EPS16 of 14.94sen. Our PER multiple is based on the historical average 12 months rolling PER of the company. Supermax is currently trading at PER of 16x, which is lower than the sector average PER of 25x. Although the stock valuation is relatively compelling, nonetheless we remain cautious on the group's ability to sustain its profit margins as additional operating expenses (marketing expenses to market its OBM products in particular) might cause profit margin erosions moving forward.

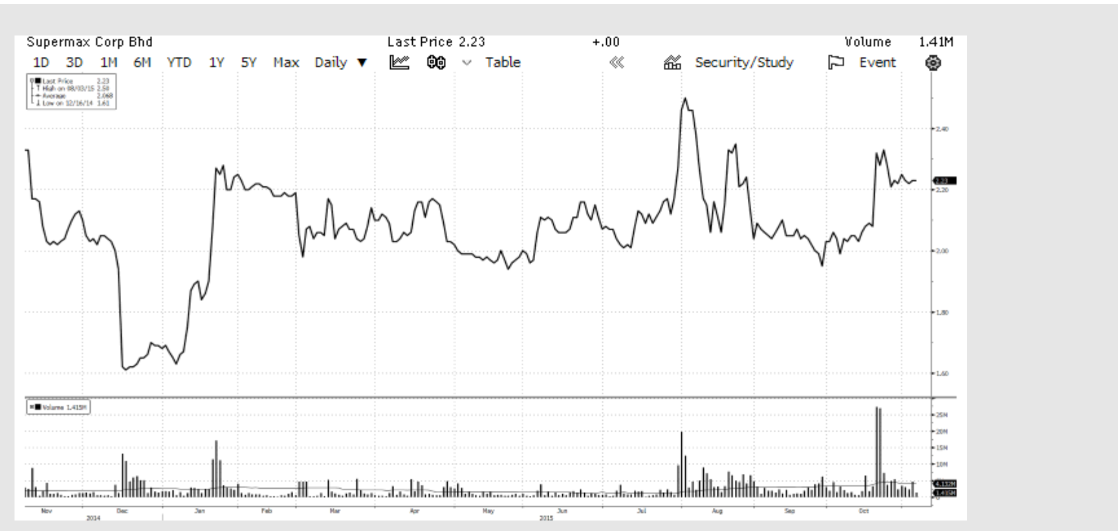
COMPANY BACKGROUND

More than 25 years of history. The Supermax Group's history can be traced back to 1987, when it was founded by Dato' Seri Stanley Thai and his wife Datin Seri Cheryl Tan as a trading business distributing latex gloves. In 1989, they started their first manufacturing facility with just a small team of employees. With a particular stress on branding, Supermax ventured into own brand manufacturing and became the first OBM latex glove manufacturer in the country when it launched its first brand, Supermax.

America the largest contributor to sales. As of 2QCY15, the bulk of Supermax's revenue came from the American continent, which made up 59.0% of its total sales (40.0% North America, 4.0% Central America, 15.0% South America). This was followed by Europe at 26.0%, Asia at 8% and the remaining is made up by sales to the Middle East and African regions.

Own Brand Manufacturing (OBM). As of 2015, OBM made up 69.5% of the total sales of Supermax, with the remaining 30.5% comprised of Original Equipment Manufacturing (OEM). This is contrary to the other major local players, which generally focus more on OEM. A few of Supermax's brands that have attained worldwide recognition are Supermax, Aurelia and Maxter.

DAILY PRICE CHART



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Income statement	2012	2013	2014	2016F*^	2017F*
Revenue	**997.4**	**1048.2**	**1004.4**	**1595.2**	**1320.2**
Cost of sales	-745.4	-830.3	-812.5	-1316.0	-1082.5
Gross profit	252.0	217.9	191.8	279.2	237.6
Operating profit	122.7	139.0	126.7	200.1	155.0
PBT	137.3	148.2	128.3	199.1	153.4
PAT	**121.7**	**119.7**	**95.6**	**151.3**	**116.6**
EPS (basic)	17.9	17.6	14.1	22.2	17.1
Dividend/share (sen)	5.0	5.0	5.0	6.8	5.5
Payout ratio (%)	27.9	28.4	35.5	30.6	32.1
Dividend yield (%)	2.2	2.2	2.2	3.0	2.5
PAT margin (%)	12.2	11.4	9.5	9.5	8.8

Cash flow	2012	2013	2014	2016F*^	2017F*
Operating cash flow					
PBT	137.3	148.2	128.3	199.1	153.4
Depreciation	24.4	26.7	27.9	29.8	35.2
Finance cost	8.7	7.6	8.2	9.8	9.1
Others	-15.6	-17.8	-12.4	0.0	0.0
OP before Δ in WC	**154.9**	**164.7**	**152.0**	**238.7**	**197.7**
Δ in working capital					
Inventories	-10.6	41.1	41.2	-75.8	46.4
Payables	30.9	-17.4	23.2	97.6	-53.2
Receivables	2.5	-30.6	-31.7	29.1	-20.6
Others	-10.9	7.5	8.2	0.0	0.0
Cash from operations	**166.7**	**165.4**	**192.8**	**289.6**	**170.3**
Tax refunded	0.3	0.0	0.0	0.0	0.0
Taxes paid	-3.4	-22.2	-35.1	-47.8	-36.8
Net CF to Operations	**163.6**	**143.2**	**157.7**	**241.9**	**133.5**
Investing cash flow					
Acquisition of PPE	-69.2	-101.6	-177.6	-150.0	-100.0
Others	0.0	0.0	-0.4	0.0	0.0
Net CF to Investments	**-69.2**	**-101.6**	**-178.0**	**-150.0**	**-100.0**
Financing cash flow					
Dividend paid	-11.9	-34.0	-34.0	-46.3	-37.4
Net rpmt of term loans	-53.2	40.9	29.3	40.0	-30.0
Others	-10.8	-7.6	-12.8	-9.8	-9.1
Net CF to Financing	**-75.9**	**-0.7**	**-17.5**	**-16.1**	**-76.5**
Exchange difference	-0.2	3.4	2.0	0.0	0.0
Net increase/(decrease)	18.5	40.8	-37.7	75.8	-43.0
Cash b/f	104.5	122.9	167.1	131.9	207.7
Overdrafts and forex	0.0	0.0	0.5	0.0	0.0
Ending cash c/f	**122.9**	**167.1**	**131.9**	**207.7**	**164.7**

Balance sheet	2012	2013	2014	2016F*^	2017F*
Assets					
PPE	446.8	522.3	663.1	783.3	848.0
Intangible assets	28.7	28.7	28.7	28.7	28.7
Others	214.9	236.6	227.0	227.0	227.0
Total NCA	**690.5**	**787.6**	**918.8**	**1039.0**	**1103.7**
Receivables	105.2	142.0	182.1	153.0	173.6
Inventories	233.8	192.7	151.4	227.3	180.8
Others	101.7	94.2	88.8	88.8	88.8
Cash & cash equiv.	122.9	167.1	131.9	207.7	164.7
Total CA	**563.6**	**596.0**	**554.3**	**676.8**	**608.0**
Total assets	**1254.1**	**1383.6**	**1473.1**	**1715.8**	**1711.7**
Equity					
Share capital	340.1	340.1	340.1	340.1	340.1
Reserves	494.0	558.6	605.1	710.1	789.3
S/holder's funds	**834.0**	**898.6**	**945.2**	**1050.2**	**1129.4**
MI	-0.3	-1.0	-1.1	-1.1	-1.1
Total equity	**833.8**	**897.6**	**944.1**	**1049.1**	**1128.3**
Liabilities					
Loans	115.2	127.0	146.1	196.1	176.1
Others	20.0	38.1	42.7	42.7	42.7
Total NCL	**135.2**	**165.1**	**188.8**	**238.8**	**218.8**
Loans	162.9	195.8	206.5	196.5	186.5
Payables	117.9	101.0	118.8	216.3	163.1
Others	4.3	24.1	15.0	15.0	15.0
Total CL	**285.1**	**320.9**	**340.2**	**427.8**	**364.6**
Total liabilities	**420.3**	**486.0**	**529.0**	**666.6**	**583.4**

Ratios	2012	2013	2014	2016F*^	2017F*
Profitability ratios					
ROE (%)	14.6	13.3	10.1	14.4	10.3
ROA (%)	9.7	8.7	6.5	8.8	6.8
Net margins (%)	12.2	11.4	9.5	9.5	8.8
Liquidity ratios					
Current ratio (x)	2.0	1.9	1.6	1.6	1.7
Quick ratio (x)	1.2	1.3	1.2	1.1	1.2
Growth					
Sales (%)	-2.3	5.1	-4.2	58.8	-17.2
Profit (%)	16.9	-1.6	-20.1	58.2	-22.9

Source: Company, MIDFR Forecasts

**FYE June*

^18 months

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BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% 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.