14 April 2017 | Sector Update

Gloves

***Maintain* NEUTRAL**

Earnings growth in FY17 to be demand driven

INVESTMENT HIGHLIGHTS

- **Current elevated raw material prices to persist at least for 1H17**
- **Future costs uncertainties mitigated with better visibility for natural rubber and gas prices**
- **Price competition amongst glove producers has normalised**
- **Expecting potential shift in demand to nitrile gloves due to regulatory compliance**
- **Maintain NEUTRAL on the Rubber Gloves sector**

Unexciting earnings recorded by most glove producers. From the recently concluded earnings announcements, two out of four glove manufacturers under our coverage namely **Hartalega (NEUTRAL, TP: RM5.07)** and **Kossan (BUY, RM7.52)** recorded earnings which were within our expectations. Meanwhile, **Top Glove (NEUTRAL, RM5.11)** and **Supermax (NEUTRAL, RM2.20)** registered earnings below our full-year earnings estimates. The underperformance from the two glove producers was mainly due to higher raw materials price during the quarter. This resulted in earnings downgrade for three out of four manufacturers as well as revised target price for all three glove manufacturers.

Table 1: Glove sector's earnings report card

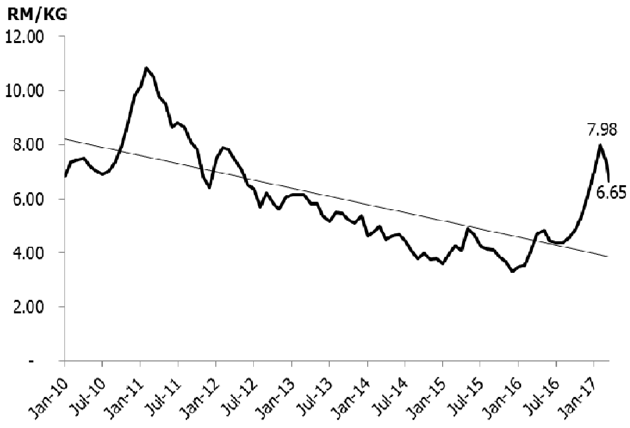
Glove Companies	Recommendation Upgrade/ Downgrade	Previous Recommendation	New Recommendation	Previous TP	New TP
Hartalega	Maintained	NEUTRAL	NEUTRAL	RM4.48	RM5.07
Top Glove	Maintained	NEUTRAL	NEUTRAL	RM5.31	RM5.11
Kossan	Maintained	BUY	BUY	RM7.85	RM7.52
Supermax	Maintained	NEUTRAL	NEUTRAL	RM2.42	RM2.20

Source: MIDFR

Big jump in natural rubber price marred earnings. Raw material prices especially natural rubber, has increased by about +129% from an average of RM3.56 per kg back in February 2016 to as high as RM8.16 per kg on 2nd February 2017. As mentioned in our previous sector report issued on the of 6th December 2016, we note that the increase in natural rubber price last year was mainly due to the increase in passenger car demand in China. However, the price continues to increase even further earlier this year due to the unseasonal flash flood that hit southern Thailand in late December 2016 which further applied upward pressure on natural rubber prices. Due to this, the Thai government industry official expects that its 2016-2017 rubber output will reduce by 10% following the development that affected the country's main rubber growing region. Note that Thailand is currently the world's largest rubber producer.

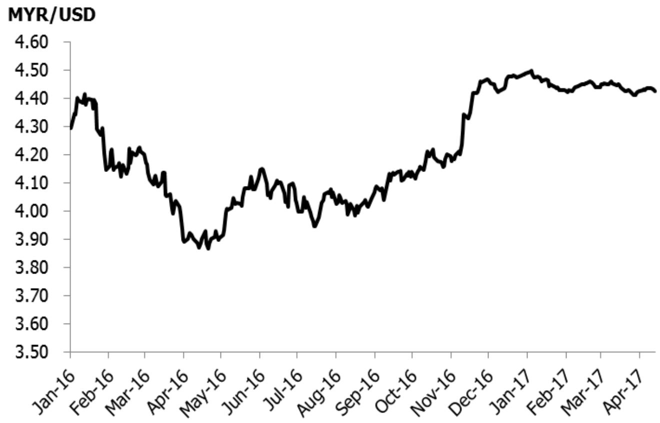
Current raw material price to persist at least for the 1H17. Due to the recent development we opine that natural rubber price will continue to trade between the range of RM6-8 per kg for the first half of 2017. Furthermore, we reiterate our view that the natural rubber price will continue to remain at the current level due to the annual wintering season which takes place from March to May. This will cause rubber supply to dip further as wintering season will typically cause rubber supply to be lower than normal. However, we do not think this situation will prevail throughout the year as China's passenger car purchase tax has been increased to 7.5% for 2017 (up from 5% in 2016). This will reduce the double digit growth experienced by China's automotive sector last year to a single digit growth this year according to industry officials.

Chart 1: Natural rubber price trend



Source: Bloomberg, MIDFR

Chart 2: USD/MYR trend



Source: Bloomberg, MIDFR

More visibility on future cost increases. With the announcement made by **Gas Malaysia Berhad (BUY, TP: RM3.33)** earlier in January 2017 on the quantum of gas price increases that will take place going forward until 2019, we are of the view that future gas price uncertainties have been alleviated. In addition, the deferment of the new foreign worker levy changes to next year (from this year originally) will also assists to reduce the uncertainties associated with future cost increases. To recall, back in January 2017, the government announced that foreign worker levies will now be fully borne by the employers. The new change in the policy however, will only affect some of the producers which are currently not paying the levy on behalf of their foreign employees.

Chart 3: Natural gas price hike schedule

Effective period	Base tariff (RM per MMBtu)
January to June 2017	26.71
July to December 2017	28.05
January to June 2018	30.90
July to December 2018	31.92
January to June 2019	32.69
July to December 2019	32.74

Source: Gas Malaysia Berhad, MIDFR

Price competition has finally normalised. We believe the price competition between the gloves producers have finally abated. This is largely attributable to the reduction of uncertainties on future costs increases. We reiterate our view that it is now a buyer's market as scalability is no longer an issue for all producers. Therefore, we opine that the producers will now be focusing on volume and lean manufacturing to drive revenue growth.

Potential shift in demand due to regulatory compliance to benefit glove producers. We note that China recently signed the Paris Climate Agreement (PCA) which requires it to comply with strict environmental policies while conducting business. This also applies to vinyl plastic gloves manufacturers which will now incur additional costs in order to comply with the new environmental policies and to continues its operations. Note that China is the largest producer as well as consumer of vinyl plastic gloves. Therefore, due to the new compliance to PCA, we opine that the price of vinyl plastic gloves will increase which could potentially drive the shift from vinyl plastic gloves to rubber gloves. The Malaysian rubber gloves manufacturers could potentially benefit from this shift due to lower input costs as well as better scalability to cater for large demand.

In addition, the US Food and Drug Administration (FDA) recently announced that it is implementing a complete ban on powdered medical and surgical rubber gloves due to the potential allergic reaction that might be triggered by the protein content in powdered rubber gloves. This might be the first of many such regulations to come from developed countries as the allergic reaction to the protein content in powdered rubber gloves is mainly present in the Western countries. In our opinion, the Malaysian rubber gloves producers will benefit from this through an expected increase in sales volume for nitrile gloves which commands better margin compared to natural rubber gloves.

Maintain NEUTRAL. All factors considered, despite a more positive outlook for the rubber gloves sector this year, we are of the opinion that the near term prospects for some of the rubber glove producers will remain challenging. This is largely due to the delay in capacity expansion for some of the producers caused by on-site utilities issue. Moreover, the upside earnings potential of these producers might be capped due to unfavourable currency movements, further exacerbated by adverse raw material price fluctuations. Hence, we are maintaining our **NEUTRAL** stance on the sector in view of the near term challenging operating environment as well as the lack of strong catalysts for the sector at this juncture with **Hartalega** and **Kossan** as our Top Picks for the sector. We like Hartalega for its: (i) earnings visibility, (ii) superior profit margins compared to its peers, (iii) efficient cost management and; (iv) prudent management. Meanwhile, we like Kossan for its: (i) earnings visibility; (ii) prudent management and; (iii) newly revamped production lines which increased its production capacity without adding new production lines.

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STOCK RECOMMENDATIONS	
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.