07 June 2018 | Sector Update

Gloves Sector

***Maintain* NEUTRAL**

Healthy global demand to drive earnings in 2H18

INVESTMENT HIGHLIGHTS

- **Earnings within estimates for most glove producers**
- **Resilient global demand to continue driving earnings**
- **Current raw materials prices to persist at least for 2H18**
- **Stable USD will be more beneficial to gloves manufacturers in the long term**
- **Awaiting further clarity on new government policies**
- **Maintain NEUTRAL on the Gloves sector**

Earnings within estimates for most glove producers. In the recently concluded earnings announcements, three out of four glove manufacturers under our coverage namely **Hartalega (NEUTRAL, TP: RM5.49), Top Glove (NEUTRAL, RM9.46)** and **Supermax (NEUTRAL, RM3.31)** recorded earnings which were within our expectations. Meanwhile, **Kossan (NEUTRAL, RM7.55)** registered earnings below our full-year earnings estimates. The underperformance from Kossan was mainly due to the lag in transferring the +23% hike in natural gas tariff during the quarter as well as the delay in its capacity expansion which resulted in earnings downgrade for Kossan for both FY18-19F. We have also increased our earnings estimate for both Top Glove and Supermax. That said, despite the earnings upgrade we have downgraded our recommendation on Supermax to NEUTRAL (from BUY previously) as the share price have surged by +68% since our upgrade back in November 2017 which leaves limited room for price appreciation going forward.

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	RM4.83	RM5.49
Top Glove	Maintained	NEUTRAL	NEUTRAL	RM9.19	RM9.46
Kossan	Maintained	NEUTRAL	NEUTRAL	RM8.78	RM7.55
Supermax	Downgraded	BUY	NEUTRAL	RM3.09	RM3.31

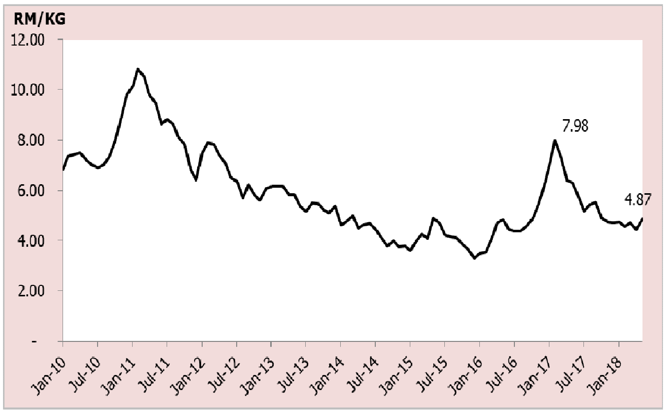
Source: MIDFR

Resilient global demand to continue driving earnings. During the 1QFY18 earnings announcement period, we understand that earnings for some companies have been subdued due to the +23% hike in natural gas tariff which took place from January 2018. The companies experienced a lag effect of about two months before the +23% increase in natural gas tariff was able to be fully transferred to their customers. That said, our analysis shows the blended average selling prices (ASPs) for the gloves have increased less than 23%, meaning that there could potentially be further price increase in 2Q18. Therefore, we believe that the gloves producers could potentially record better earnings in the quarters to come due to the adjustments in pricing and new capacity expected to come on board in 2H18. Additionally, we opine that the resilient global demand for gloves will continue to drive the earnings for the gloves producers in 2H18. Malaysian Rubber Glove Manufacturers Association (MARGMA) projected that the export for glove will increase by +10% to RM18b from RM16.2b in 2017 in line with the increase in global demand of 8-10% per annum. In terms of number of pieces, MARGMA projected Malaysia will export 232b pieces in 2018 (vs 228b pieces in 2017) and 287b pieces per annum by 2020.

Current raw material price to persist at least for the 2H18. We opine that natural rubber price will continue to trade between the ranges of RM4.50-RM5.00 per kg for the rest of 2018 mainly due to the Tripartite Agreement between the three major natural rubber producers i.e: Thailand, Indonesia and Malaysia that prevents the price of natural rubber to fall below RM4.00/kg. Furthermore, we reiterate our view that the natural rubber price will continue to remain at the current level as China's passenger car purchase tax has been restored to 10% (from 7.5% in 2017 and 5% in 2016). This will reduce the double digit growth experienced by China's automotive sector last two years to potentially a low single digit growth of +3.0%yoy this year according to China's automotive industry officials.

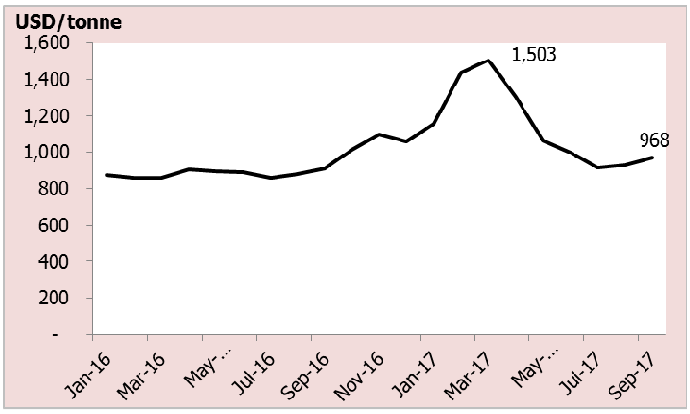
That said, we also understand that despite ending the tax incentive policy for compact cars with an engine displacement of 1.6litres and below, starting in January 2018 the government of China has introduced purchase tax exemption for New Energy Vehicles (NEV) for the period of three years which could gradually alleviate the price of natural rubber from 2019 onwards. This is as the automakers are currently developing a production system to accommodate the NEV credit scheme that will be implemented in 2019. As for nitrile butadiene (NBR) price, we opine that the price would be trending upwards as the demand for nitrile gloves increases worldwide. Due to this, we estimate that the price of NBR could increase by a further 5-10% from its current price to an average of USD1,000 - 1,100/tonne for the rest of the year.

Chart 1: Natural rubber price trend



Source: Bloomberg, MIDFR

Chart 2: Nitrile butadiene price trend



Source: Bloomberg, MIDFR

Stable USD will be more beneficial to gloves manufacturers in the long term. Though a stronger USD will boost revenue for gloves manufacturers as the export of gloves are USD-denominated, however, we opine that the current stable USD condition is more beneficial to the gloves manufacturers in the long term as it provides better visibility in terms of both revenue as well as costs. In addition, it will also assist in currency hedging for the gloves manufacturers and reduce potential foreign exchange losses. Our house view with regards to USD to MYR is that MYR will continue to fluctuate at current level and settling at RM3.95 per USD by end-2018.

Chart 3: USD/MYR trend

Source: Bloomberg, MIDFR

Awaiting further clarity on new government policies. Due to the change in Federal Government post Malaysia's 14th General Elections, the gloves sector is now facing some uncertainty with regards to some of the policies that the new Federal Government has highlighted in its election manifesto. These policies include: (i) to increase minimum wage to RM1,500 and; (ii) to reduce foreign labours by -2.0m in stages. In general, the implementations of these two policies are negative to the sector due to the companies' dependence on foreign labours. That said, the recent announcement from Minister of Human Resource stated that there will be an increase of minimum wage however, the quantum of increase would be lower than the +RM500 that was earlier announced. The actual amount to be increased will be made known sometime in August. Despite the lower increase, the government is still determined to increase the minimum wage to RM1,500 but it will be implemented at a later time. According to our estimates, a +RM500 increase in minimum wage will reduce the earnings of gloves producers by RM1.5-3.0m (or by 2.0-4.0%) depending on the company. However, we opine that the gloves companies will be transferring the increase to their customers as per the usual practice.

As for the gradual reduction in foreign labours, despite being highly dependent on foreign labours currently (70-80% of total workforce in gloves companies are foreign labours) we understand that the companies will be investing more on automation going forward to reduce the dependency and to avoid hurting their earnings. Labour costs currently make up about 12-14% of total gloves production costs and this could be reduced significantly with automation.

Maintain NEUTRAL. All factors considered, despite a 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 subdued due to the constraint in terms of capacity. This is largely due to the delay in capacity expansion for some of the producers caused by incomplete parts of the production lines. Moreover, the upside earnings potential of these producers might be capped due to closure of some production lines for upgrades and revamps. Hence, we are maintaining our **NEUTRAL** stance on the sector in view of the capacity constraint as well as; the lack of strong catalysts for the sector at this juncture with **Supermax** as our Top Picks for the sector. We like Supermax for its: (i) attractive valuation at 11.4x FY19F PER vs its peers of >20x FY19F PER; (ii) revamp of older production lines which helped to boost productivity and; (iii) efficient cost management.

Noor Athila Mohd Razali
noor.athila@midf.com.my
03-2772 1679

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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 news flow.
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 news flow.
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.