06 December 2016 | Sector Update

Glove Sector

***Downgrade to* NEUTRAL**
(*previously* POSITIVE)

Limited near term growth

INVESTMENT HIGHLIGHTS

- **Lacklustre earnings recorded by most glove players**
- **Earnings affected by various external cost increases**
- **Pricing competition to persist at least for the next two years**
- **Raw material prices on an increasing trend**
- **New BNM policy of converting 75% foreign proceeds into MYR counterproductive**
- **Stronger USD will be beneficial but not sustainable in the longer term**
- **Downgrade the sector to NEUTRAL**

Lacklustre earnings recorded by most glove players. From the latest earnings announcements, three out of four glove manufacturers under our coverage registered earnings below our full-year earnings estimates. Hartalega (NEUTRAL, TP: RM4.48) was the only glove player that recorded earnings improvement and which came in within our expectation. This resulted in earnings downgrade for the three manufacturers as well as two downgrades in recommendation to NEUTRAL (from BUY recommendations previously).

Table 1: Glove sector's earnings report card

Glove Companies	Upgrade/ Downgrade	Previous Recommendation	New Recommendation	Previous TP	New TP
Hartalega	Maintain	NEUTRAL	NEUTRAL	RM4.48	RM4.48
Top Glove	Downgrade	BUY	NEUTRAL	RM6.28	RM5.24
Kossan	Maintain	BUY	BUY	RM8.60	RM7.85
Supermax	Downgrade	BUY	NEUTRAL	RM3.02	RM2.42

Source: MIDFR

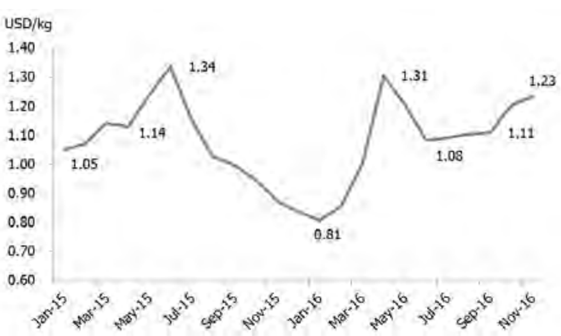
Earnings affected by various external cost increases. Most of the glove manufacturers' earnings for 3QCY16 were adversely impacted by various external cost increases. The hike in minimum wage as well as the increase in natural gas price which took effect in 3QCY16 caused the earnings of glove manufacturers to be negatively impacted. This is because it takes about two to three months for these costs increases to be incorporated into the average selling prices (ASPs) to be borne by the customers. Generally, prices are locked in upon confirmation of order which would then take roughly two months to be completed. Therefore, the increases in costs which took place in between these times would not be transferred to the customers. That said, we think that this is a temporary blip as we believe that the conditions will improve once the costs are factored into the ASP starting from 4QCY16 onwards.

Pricing competition to persist at least for the next two years. We opine that pricing competition between the glove manufacturers especially in the nitrile segment will persist for at least the next two years until 2018 as new capacity for nitrile glove production comes on board from all the four major rubber glove manufacturers. It is now a buyers' market due to the expanded glove production capacity now available to these manufacturers. The glove manufacturers will need to be more competitive in terms of pricing as scalability is no longer an issue, unlike two to three years ago. This is made worse by the various production cost increases mentioned earlier.

To overcome this, we think that the manufacturers will try to ensure that the input costs per glove stays low via: (i) increasing automation in production process; (ii) pushing for higher utilisation rate; (iii) concentrating on customers that are less price sensitive; as well as (iv) having an efficient cost pass-through mechanism. Additionally, we think that the margin compression resulted from the pricing competition will slowly normalise as all the new capacity comes in and the manufacturers would have adapted to the increased production costs.

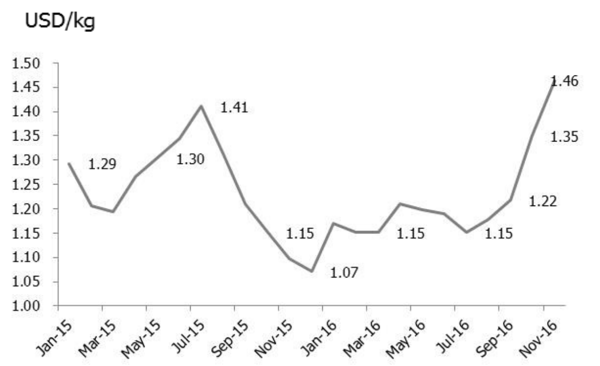
Raw material prices on an increasing trend. We note that the raw material prices have been slowly creeping up since late September 2016. From our channel checks, we understand that the increase in natural rubber price is mainly due to the increase in demand for motor vehicles in China. This is pursuant to the purchase tax cut on motor vehicles with engine capacities of 1.6 litres and below by the government of China from 10% to 5% which drove the demand for natural rubber with respect to the production of tyres. According to China Passenger Car Association (PCA), sales of motor vehicles with engine capacities of 1.6 litres and below have increased by more than 20% month-over-month ever since the tax cut was introduced. The tax incentive is expected to expire by year-end and the Chinese auto makers are expecting an eleventh-hour surge in sales as customers rush to beat the tax-cut expiration.

Chart 1: Natural rubber price trend



Source: Bloomberg, MIDFR

Chart 2: Nitrile butadiene price trend



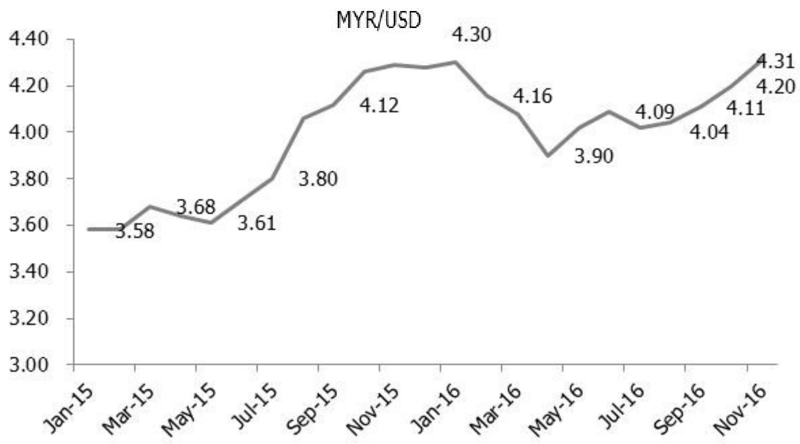
Source: Bloomberg, MIDFR

Meanwhile, the increase in nitrile price is due to both increases in natural rubber price as well as the temporary shutdown of petrochemical plants in China that produces nitrile butadiene. We understand that the temporary shutdown is due to maintenance works as well as refurbishment done on the production plants. We think that the increasing price trend for both natural rubber and nitrile butadiene will continue until the first half of 2017. This is due to annual wintering season for rubber trees (from March until May) which will cause rubber price to remain elevated as supply for natural rubber declines during the period.

Stronger USD will be beneficial but not sustainable in the longer term. The current MYR weakness against USD is arguably a result of policy uncertainty brought upon by the recently concluded US general election. In addition, the market is expecting that there will be a rate hike by the US Federal Reserves in December. Admittedly, the strong USD will contribute positively in terms of revenue and earnings especially when export of gloves is USD denominated. However, we do not think the strong USD will persist throughout 2017 as we opine that once the uncertainty in regard to the policies of the newly elected US president subsides, the USD will give back some of its recent gains.

BNM policy may result in double conversion by rubber glove exporters. Bank Negara Malaysia announced that effective 5 December 2016, exporters holding proceeds in foreign currency would need to convert as much as 75% of it into Ringgit. It was one of several other measures announced to support the falling Ringgit. As the bulk of revenue for rubber glove manufacturers are denominated in foreign currency, USD is normally used as a natural hedge for the purchase of raw material prices such as nitrile, latex and chemicals. This new policy will result in glove manufacturers having to execute double conversion as USD revenue is converted into MYR and back into USD for expenditure purposes.

Chart 3: MYR/USD trend movement



Source: Bloomberg, MIDFR

Downgrade the sector to NEUTRAL. Based on the expected global demand for rubber gloves which is expected to grow by 8-10% annually, we think that the prospect for gloves is still positive in the long run. This is given the fact that Malaysian rubber glove manufacturers have the advantage against their competitors abroad in terms of both cost efficiency as well as scalability. The Malaysian glove manufacturers currently commands roughly 58% of total rubber gloves supply and we think that there is potential for the market share to increase to >60% in the medium term given the ongoing capacity expansion undertaken by the Malaysian glove manufacturers currently.

All factors considered, we are of the opinion that the near term prospects for the rubber glove industry will be challenging as: (i) raw material prices are expected to continue trading at current level and maybe even higher due to the upcoming wintering season for the natural rubber (March-May annually); (ii) strong USD might not persist for an extended duration; and (iii) new BNM policy counterproductive to rubber glove manufacturers. Hence, we are downgrading the sector to **NEUTRAL** (from POSITIVE) in view of the near term challenging operating environment as well as the lack of upward catalysts for the sector at this juncture.

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 >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.