04 February 2016 | Sector Update

Rubber Gloves

Maintain POSITIVE

Minimal impact from rise in foreign workers levy

INVESTMENT HIGHLIGHTS

- **Foreign workers levy raised to RM2,500 from RM1,250**
- **Still unclear which party will bear the additional cost**
- **Minimal impact on earnings**
- **Maintain POSITIVE on the sector**

Foreign workers levy raised to RM2,500 from RM1,250. The government recently announced that it will restructure the foreign workers levy rates effective 1st of February 2016. The new levy will be divided into two types: i) plantations and agriculture, as well as ii) manufacturing, services and constructions. Under the new structure, the new levy rate for plantations and agriculture will be RM1,500 (from RM950 previously) while for manufacturing, services and construction, the new levy rate will be raised to RM2,500 (from RM1,250 previously) per foreign worker. The news of the restructuring came in as a surprise to both the industry players and the market as the announcement was sudden and the quantum of the increase is significant. We expect the levy hike to impact the earnings of glove players, albeit marginally, as Hartalega (HART MK, NEUTRAL, TP: RM5.58/share) and Kossan (KRI MK, NEUTRAL, TP: RM7.84/share) employ about 3,000-3,200 foreign workers while Top Glove (TOPG MK, NEUTRAL, TP: RM6.76/share) employs about 6,000-7,000 foreign workers. The increase in foreign workers levy is expected to bring in RM2.5bn worth of revenue to the government.

Table 1: Foreign workers levy hike comparison

Sectors	Previous Levy (RM per worker)	New Levy (RM per worker)	(%) +/-
Plantations and agriculture	950.0	1,500.0	57.9%
Manufacturing, services and construction	1,250.0	2,500.0	100.0%

Source: MIDFR

Who will bear it? At this juncture, it is still unclear which party will be responsible for the additional increase in foreign workers levy. Unlike the plantations sector where the employers are paying for the levy, the industry-wide practice for the glove players currently is that the foreign workers are paying for the current levy of RM1,250 via monthly salary deductions of RM100 a month. With this new increase to RM2,500, each employees are now expected to have RM200 deducted from their monthly salary should the employees continue to bear the levy. Pending further confirmation from the government and assuming that the employees will continue to bear the new increase in levy, we think this increase will offset the RM100 increase in salary per month from the newly implemented minimum wage policy.

On another note, we understand that if Malaysia were to ink the Trans-Pacific Partnership Agreement (TPPA), the employers will have to bear the entire foreign workers levy in the future. However, our channel checks shows that this will only take effect 2-3 years (from 2018 onwards) after the TPPA is ratified and operational.

Minimal impact on earnings. Should the employers be made to pay for the additional increase in levy, our back of the envelope calculation shows that it will increase the cost for the glove players by RM0.10-RM0.15sen per 1,000pcs of gloves or RM4-4.5m increase in labour cost per annum. This is turn will reduce the players' net profit by 1.5-2% per annum. Our checks with the gloves players suggest that should this be the case, the players might be passing on the cost increase to their customers by increasing their ASPs. This does not come as a surprise as the practice of passing on the increase in cost or cost saving to their customers is a norm in the rubber glove industry. We are also expecting no impact on volume as the players gradually ramp up production capacity to meet the increasing demand.

Furthermore, some of the players have also opted to reduce their number of foreign workers to mitigate the impact of the increase. Top Glove for example has announced on Tuesday that it is targeting to reduce its foreign workers dependency by 5% or 300 workers. Previously, Top Glove has reduced about 1,000 foreign workers in the past 2-3 years with the increase in automation of its manufacturing processes.

Table 2: Scenario analysis

Increase in foreign workers levy	Impact on net profit	Impact on cost	Impact on volume	Impact on Target Price
Paid by employees	No impact	No impact	No impact	Unchanged
Paid by employers (if cost is absorbed by company and not passed on to customers)	1.5-2% reduction in net profit	RM0.10-0.15sen increase per 1,000 gloves	We expect no impact on volume as glove players gradually increase production capacity	A reduction of RM0.10-0.13sen from current TP
Previous increase in natural gas tariff				
Fully passed on to customers	No impact	RM0.15-0.20sen increase per 1,000 gloves	No impact	Unchanged

Source: MIDFR

Maintain POSITIVE on the sector. While the increase in foreign workers levy in general is negative news for the overall sector, however, as mentioned earlier, the impact on earnings will be fairly minimal at 1.5-2% reduction in net profit. Furthermore, it must be noted this is assuming that: i) the employers were to bear the additional increase in levy, and ii) the increase in labour cost is not passed on the customers. We remain positive on the sector as we opine that the: i) gradual increase in glove production capacity of the players, as well as ii) the resilient demand for rubber gloves globally will eventually offset the increase in labour cost going forward.

Additionally, as the glove players gradually increase the production efficiency as well as manufacturing automation, we think that, going forward, the dependency to foreign workers will gradually reduce as well. Our Top Pick for the sector is Top Glove mainly due to its: i) well-diversified customer base, ii) attractive valuation against peers, and iii) wider product mix.

Table 3: Rubber Gloves Peer Comparison Table

Company	Bloomberg Ticker	Market Cap* (RM'm)	Current Price* (RM)	Target Price (RM)	FY16F EPS	FY17F EPS	FY16F P/E	FY17F P/E
Hartalega	HART MK	8,877.3	5.41	5.58	16.8	19.3	32.1	28.1
Top Glove	TOPG MK	7,298.4	5.84	6.76	33.7	35.5	17.3	16.4
Kossan	KRI MK	4,738.5	7.41	7.84	31.3	35.6	23.7	20.8
Supermax	SUCB MK	2,054.1	3.06	U. Review	22.1	17.1	13.8	17.9
Average							**21.7**	**20.8**

**Market cap and current price is based on closing price on 3 February 2016.*
Source: Bloomberg, MIDFR

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NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
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