

Sector Update

NEUTRAL (downgrade)

Absolute Performance (%)

	1M	3M	12M
Kossan	-5.0	-0.3	-2.4
Supermax	-6.5	-3.8	-10.7
Top Glove	-6.8	-12.0	-13.7
Hartalega	-2.2	+34.0	+43.2
Adventa	-1.3	-7.2	-33.6
Latexx	-10.1	-26.4	-48.7
KLCI	+0.6	+5.6	+3.0

Changes in EPS

	Core net profit forecast (RMm)		
	Curr year	Pros+1	Pros+2
Change in EPS			
Top Glove	-1.1%	-1.1%	-2.2%
Supermax	-4.6%	-9.5%	-11.0%
Kossan	-10.7%	-11.5%	-9.6%
Hartalega	0.0%	-4.7%	-4.6%

Changes in ratings and TP

	Prior	Current
Top Glove	REDUCE	REDUCE
Supermax	BUY	ADD
Kossan	BUY	ADD
Hartalega	BUY	ADD
Target price		
Top Glove	4.85	4.20
Supermax	2.60	2.10
Kossan	4.04	3.50
Hartalega	9.20	8.05

Shakira Hatta
(603) 2142 8158
shakira@affininvestmentbank.com.my

Peers comparison

Stock	Rating	Sh Pr (RM)	TP (RM)	Mkt Cap (RMm)	Core PE (x) CY12	Core PE (x) CY13	EPS growth (%) CY12	EPS growth (%) CY13	EV/EBITDA (x)	P/B (x)	ROE (%) FY12	ROE (%) FY13	Net Div Yield (%) FY12	Net Div Yield (%) FY13
Kossan	ADD	3.25	3.50	1,039	9.5	8.3	19.6	14.8	5.4	1.7	19.7	19.5	2.5	2.8
Top Glove	REDUCE	4.49	4.20	2,778	16.7	15.4	28.6	8.5	9.3	2.3	13.6	13.6	2.4	2.7
Supermax	ADD	1.88	2.10	1,279	9.9	9.0	16.7	10.2	11.4	1.2	14.1	12.8	3.2	3.7
Hartalega	ADD	7.92	8.05	2,892	13.7	12.4	4.7	10.6	9.2	4.8	36.4	32.3	3.2	3.4
Adventa**	NR	1.54	na	235	10.6	7.7	220.1	37.8	8.0	1.1	12.1	n.a.	4.9	4.9
Latexx**	NR	1.42	na	316	6.0	5.1	20.3	16.6	3.4	1.2	16.7	17.4	3.4	3.9
Simple average					11.1	9.7	51.7	16.4	7.8	2.1	18.8	19.1	3.3	3.6

**based on consensus estimates

A nitrile glove price war looming ahead

Sector downgrade to NEUTRAL

We are downgrading our sector recommendation for rubber gloves from OVERWEIGHT to **NEUTRAL**, premised on two key factors: 1) an anticipated nitrile glove price war in 2H12, as glove manufacturers ramp up production of nitrile gloves, and; 2) limited upside to share prices that have already fully priced in the anticipated earnings recovery from the 2011 latex price decline.

Further margin recovery is hindered by nitrile glove price competition

Although the 42% decline in latex price from its peak in April 2011 to RM6.30/kg in January 2012 have helped to lift margins, we note that margins recovery have somewhat stalled lately. Both Supermax and Kossan reported EBIT margin compression of -0.4-0.9-ppt qoq in 4Q11, despite average latex price declining by -16.4% qoq. The weaker margins, we opine, is an indication of intensifying price competition in the nitrile glove segment. This is evident in Hartalega's latest results – EBIT margin fell sharply from a high of 34.7% in 4QFY03/11 to 26.7% in 3QFY03/12, despite volume sales growth of +5% qoq.

Increase in production capacity makes a price war inevitable

To fulfill the strong demand for nitrile gloves, all four major glove manufacturers' recent capacity expansions are centred on nitrile gloves. The influx of nitrile glove production capacity makes a price war inevitable. Both Hartalega and Supermax guided that they will be more aggressive in pricing their nitrile gloves, particularly in 2H12. With Hartalega as the segment leader, we expect Top Glove and Kossan to follow suit, thus compromising the much-desired higher margins associated with nitrile gloves. Furthermore, margin compression will also be exacerbated by higher raw material costs. Altogether, we expect operating margins for nitrile gloves to fall from 15-20% to 11-15%, on par with NR gloves.

Impact on earnings

We raise our average CY12-14 nitrile latex price assumption from US\$1,700-1,800/mt to US\$1,800-2,000/mt and impute in a lower cost-pass through rate of 80% (previously, 90%). This leads to a 1-11% cut in our FY12-14 earnings forecasts for Hartalega, Supermax, Kossan and Top Glove. We lower our recommendation for Kossan (TP: RM3.50), Hartalega (TP: RM8.05) and Supermax (TP: RM2.10) to an ADD. Maintain REDUCE for Top Glove, with a lower target price of RM4.20.

Earnings recovery fully priced in and earnings risk on the downside

After rebounding by +36-102% between Oct 2011 and Jan 2012, share prices of Kossan, Supermax and Top Glove have since retreated by -12-20%. We think that the anticipated earnings growth and margins recovery from 2011's latex price decline has been fully priced in. We see limited upside to share prices, barring: 1) a fall in nitrile as well as natural latex prices; 2) stronger-than-expected demand, or; 3) better-than-expected cost pass through rate due to delays in nitrile glove capacity expansion plans.

Downgrading sector to NEUTRAL

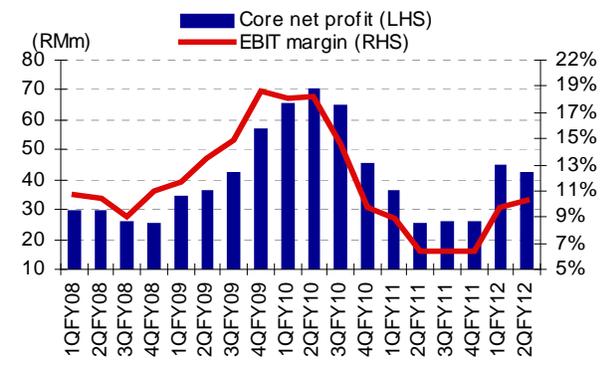
We are downgrading the rubber gloves sector from OVERWEIGHT to **NEUTRAL**. Latex price has held steady at c. RM7.80-7.90/kg since February 2012, due to the wintering period and the Thai government's 15bn baht rubber price intervention plan. As the wintering period ends and the short-term impact of the intervention plan wears off, we expect latex price to moderate from late 2Q12 onwards. In this aspect, glove manufacturers will be better off compared to 2011 – a lower and stable latex price allows glove manufacturers to better manage input costs as well as cost pass-through. That said, our downgrade is premised on two key factors: 1) an anticipated nitrile glove price war in 2H12, as glove manufacturers ramp up production of nitrile gloves, and; 2) limited upside to share prices that have already fully priced in the earnings recovery from 2011.

Margins stumbled in 4Q11

Latex price decline in 2011 was a relief...

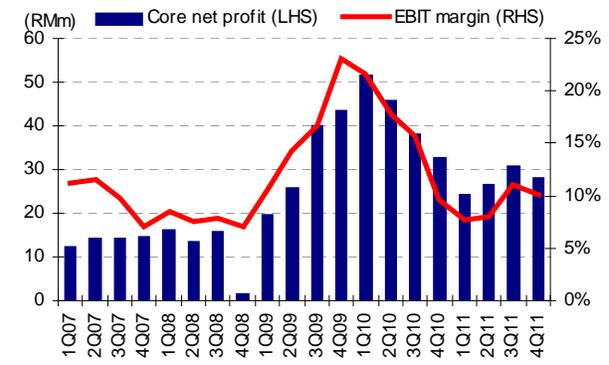
The 42% decline in latex price from its peak in April 2011 to RM6.30/kg in January 2012 was a much needed respite for glove manufacturers. Lower raw material costs and time lags in passing on cost savings to customers (i.e. slower downward ASP revisions) helped lift margins. Supermax's EBIT margin improved from 7.6% in 1Q11 to 11% in 3Q11, while Kossan added on +1.5-ppt between 2Q11 and 3Q11. The impact was slightly delayed for Top Glove – EBIT margin was flat at 6.4% from 2QFY08/11 to 4QFY08/11 before improving to 10.4% in 2QFY08/12.

Fig 1: Top Glove core net profit & EBIT margin



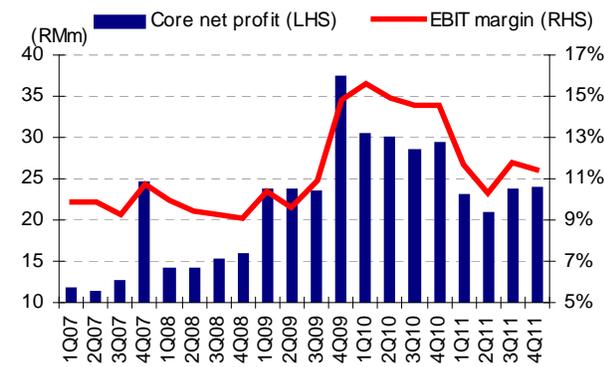
Source: Company, Affin

Fig 2: Supermax core net profit & EBIT margin



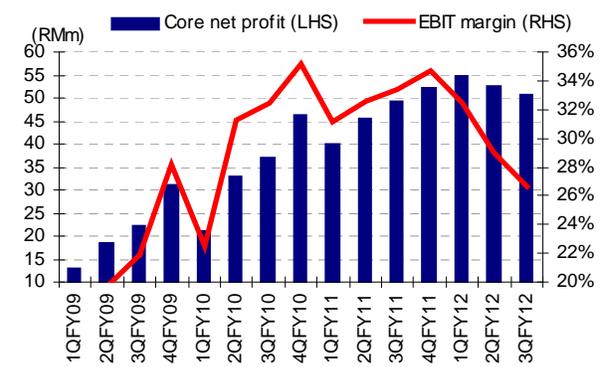
Source: Company, Affin

Fig 3: Kossan core net profit & EBIT margin



Source: Company, Affin

Fig 4: Hartalega core net profit & EBIT margin



Source: Company, Affin

...but a new challenge reared its head

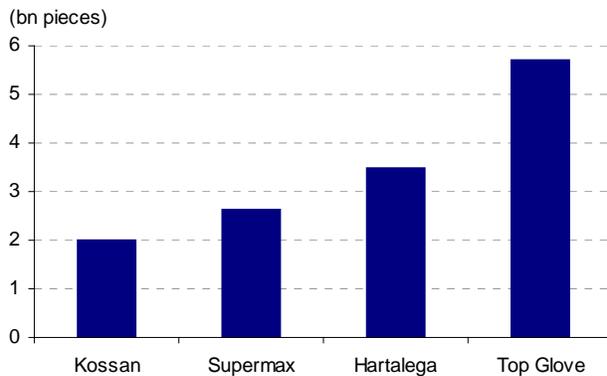
However, we note that margins recovery have somewhat stalled lately. Both Supermax and Kossan reported EBIT margin compression of -0.4-0.9-ppt qoq in 4Q11, despite an average latex price decline of -16.4% qoq. Supermax's management explained that this was due to the clearance of higher cost inventories from its associates. Nevertheless, we opine that the weaker margin is also an indication of intensifying price competition in the nitrile glove segment. This is evident in Hartalega's latest results – EBIT margin fell sharply from a high of 34.7% in 4QFY03/11 to 26.7% in 3QFY03/12, despite volume sales growth of +5% qoq.

On the brink of a nitrile glove price war

An influx of nitrile glove production capacity...

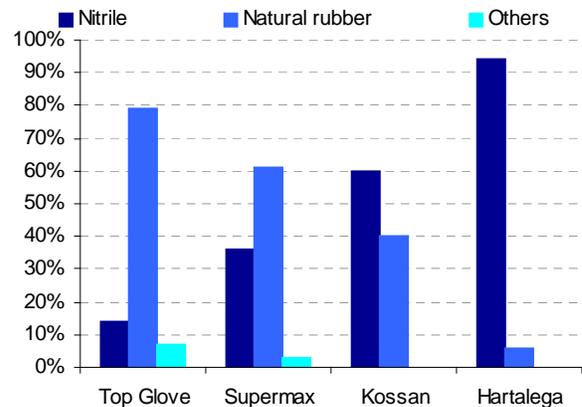
When latex price was at its highest, NR gloves were priced at a 40-45% premium to nitrile gloves. This prompted a sharp shift in demand from NR gloves to nitrile gloves, particularly from developed nations. To fulfill the strong demand, all four major glove manufacturers announced that their new capacity expansion plans would be allocated to nitrile gloves. Top Glove is the most aggressive and plans to raise its annual nitrile glove production capacity by 5.7bn pieces by end-August 2012. Hartalega, Supermax and Kossan are also raising their annual nitrile glove production capacity by 3.5bn pieces, 2.6bn pieces and 2bn pieces, respectively. Currently, Hartalega is the largest producer of synthetic gloves, with nitrile gloves accounting for c. 94% of its total glove production. By proportion, this is followed by Kossan (40%), Supermax (36%) and Top Glove (14%).

Fig 5: New nitrile glove production capacity by end-2012



Source: Company, Affin

Fig 6: Products mix



Source: Company, Affin

... makes a nitrile glove price war imminent

Given the influx of nitrile glove production capacity, we opine that a nitrile glove price war is inevitable. Both Hartalega and Supermax guided that they will be more aggressive in pricing their nitrile gloves, particularly in 2H12. With Hartalega as the segment leader, we expect Top Glove and Kossan to follow suit, thus compromising the much-desired higher margins associated with nitrile gloves. At the moment, operating margins for nitrile gloves stands at 15-20%, compared to 9-11% for NR gloves. With stronger price competition, we anticipate nitrile glove margins to fall to c. 11-15%. Assuming that latex price moderates in 2Q12 onwards, this would imply that margins of nitrile gloves would be on par with NR gloves.

Margin compression exacerbated by higher nitrile latex costs

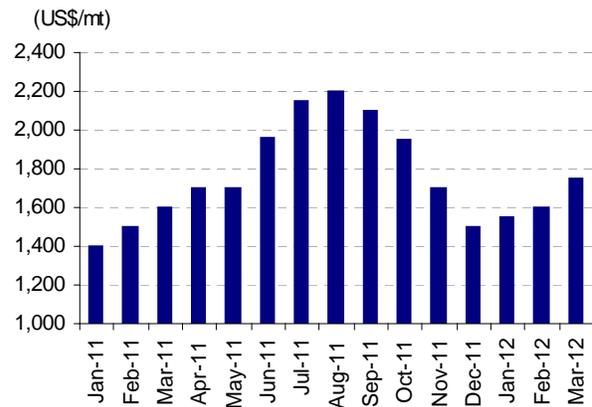
Aside from weaker pricing power, margins will also be impacted by higher raw material costs. After bottoming at c. US\$1,500/mt in Dec 2011, nitrile latex price has risen to US\$1,750/mt in March 2012. We expect the uptrend to continue, given: 1) stronger demand for nitrile latex, in tandem with the increase in nitrile glove production capacity, and; 2) rising crude oil prices, as concerns over oil supply from Iran mount. Recall that nitrile butadiene rubber is a byproduct of petroleum. Our correlation analysis yields a correlation coefficient of -0.5x, although we acknowledge that there is likely an element of a time lag in the pricing of nitrile latex.

Fig 7: Crude oil price trend



Source: Company, Affin

Fig 8: Nitrile latex price trend



Source: Company, Affin

Other upcoming concerns – earnings risk is on the downside

Aside from a nitrile glove price war, other risks include:

1. **Implementation of a minimum wage policy.** On average, staff costs account for c. 7-9% of total production costs, with unskilled labour accounting for 45-50% of the workforce. Assuming zero cost pass-through and a minimum wage of RM800-900/month, we estimate that bottomline could be impacted by c. -10%. However, we gather that there is still uncertainty on whether the minimum wage applies only to local workers or to foreign workers as well. Furthermore, we believe that the higher staff costs will be partially passed through via higher ASPs, given that the minimum wage policy would apply to the whole industry.
2. **Higher natural gas costs.** A rollback in gas subsidies, which account for c. 7-10% of total production costs, would also increase glove manufacturers' cost base. We estimate that every 5% increase in natural gas tariff would lower our net profit forecasts by up to -3% (assuming no change in selling prices).

Valuations & recommendation

We raise our average CY12-14 nitrile latex price assumption from US\$1,700-1,800/mt to US\$1,800-2,000/mt and impute in a lower cost-pass through rate of 85% (previously, 95%) for nitrile gloves. We also lower our PE targets to reflect limited upside to share price. Consequently, we make the following adjustments to our forecasts:

Hartalega – downgrade to ADD, TP: RM8.05

No change to our FY03/12 net profit forecast, but we lower our FY03/13-14 net profit forecasts by –4-5%. We expect EBIT margin to fall to 25%, before recovering to 26% in FY03/14 as operational efficiencies from Plant 6 kick in. Although Hartalega is the most exposed to the nitrile glove segment, high operational and technological efficiencies should keep overall margins ahead of its peers. We scale back our target price to RM8.05, pegged to a lower PE target of 14x (previously, 15x). Downgrade to ADD.

Supermax – downgrade to ADD, TP: RM2.10

Our FY12-14 net earnings forecasts are reduced by –7-11%. Weaker nitrile glove margins will be offset by increased production of higher margin surgical gloves. Supermax has commissioned the first surgical glove production line in Lot 42 – at full capacity, the facility will ramp up total annual surgical glove production from 30 million pairs to 336 million pairs. After lowering our PE target one notch to 12x, our target price is reduced from RM2.60 to RM2.10. Downgrade to ADD.

Kossan – downgrade to ADD, TP: RM3.50

We cut our FY12-14 net earnings forecasts for Kossan by –10-12%. Although 4Q11 saw the initial contribution from Kossan's cleanroom division (5% of revenue), rubber gloves remain the predominant earnings driver. We downgrade Kossan to an ADD, with a lower target price of RM3.50 (previously, RM4.04), pegged to a lower PE target of 10x (previously, 11x).

Top Glove – maintain REDUCE, TP: RM4.20

Given its small exposure to the nitrile glove segment (only 14% of total glove production), Top Glove is the least affected. We trim our FY08/12-14 net earnings forecasts by –1-2%. We lower our PE target to 16x, leading to a target price of RM4.20 (previously, 4.85). Maintain REDUCE.

Fig 9: Changes in earnings forecasts

	Core net profit forecast (RM m)		
	Curr year	Pros+1	Pros+2
Prior core net profit (RM m)			
Top Glove	163.4	177.3	194.6
Supermax	134.7	156.5	183.0
Kossan	122.4	141.9	152.5
Hartalega	205.9	222.7	251.3
Revised core net profit (RM m)			
Top Glove	161.6	175.4	190.3
Supermax	128.6	141.7	162.9
Kossan	109.3	125.5	137.9
Hartalega	205.9	212.2	239.9
Change in EPS			
Top Glove	-1.1%	-1.1%	-2.2%
Supermax	-4.6%	-9.5%	-11.0%
Kossan	-10.7%	-11.5%	-9.6%
Hartalega	0.0%	-4.7%	-4.6%

Source: Affin

Fig 10: Changes in target price

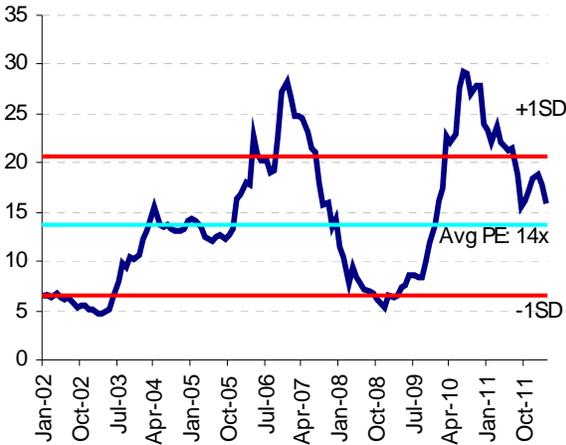
	Target price (RM)		Rating	
	Prior	Current	Prior	Current
Top Glove	REDUCE	REDUCE	4.85	4.20
Supermax	BUY	ADD	2.60	2.10
Kossan	BUY	ADD	4.04	3.50
Hartalega	BUY	ADD	9.20	8.05

Source: Affin

Earnings recovery fully priced in – downgrade sector to NEUTRAL

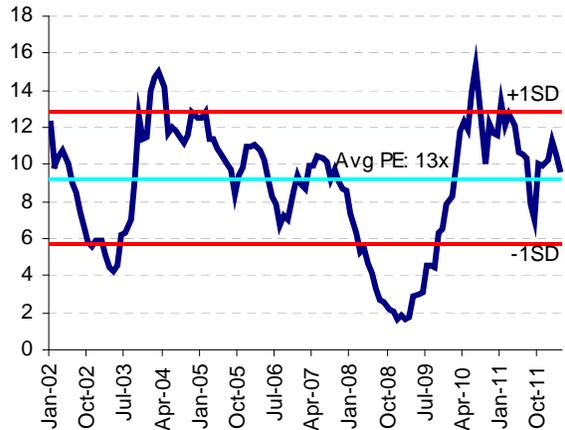
After rebounding by +36-102% between Oct 2011 and Jan 2012, share prices of Kossan, Supermax and Top Glove have since retreated by -12-20%. This is partially due to the fact that latex price has risen again (+22% YTD) in tandem with the wintering period and the Thai government's 15bn baht rubber price intervention plan. Notwithstanding that, we think that the anticipated earnings growth and margins recovery from 2011's latex price decline has been fully priced in. All four glove manufacturers are trading above their historical average forward PEs, while dividend yields have also been pared down on par with market. We see limited upside to our forecasts and share prices, barring: 1) a fall in nitrile as well as natural latex prices; 2) stronger-than-expected demand, or; 3) better-than-expected cost pass through rate due to delays in nitrile glove capacity expansion plans. We downgrade the rubber glove sector to **NEUTRAL**. Our top pick is Supermax, due to its diversification into the higher margin surgical glove division.

Fig 11: Top Glove 1-year rolling forward PE



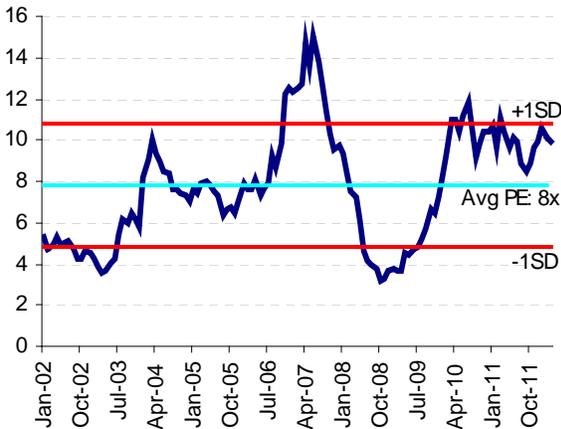
Source: Company, Affin

Fig 12: Supermax 1-year rolling forward PE



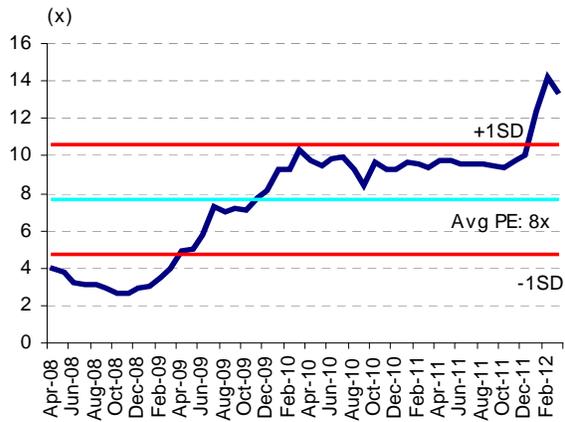
Source: Company, Affin

Fig 13: Kossan 1-year rolling forward PE



Source: Company, Affin

Fig 14: Hartalega 1-year rolling forward PE



Source: Company, Affin

Earnings Valuation & Summary

Share price chart



Top Glove (ADD, TP: RM4.20)

FYE Aug	2010	2011	2012E	2013E	2014E
Revenue (RMm)	2,079.4	2,053.9	2,252.1	2,436.2	2,730.6
EBITDA (RMm)	361.3	195.8	269.5	289.3	316.0
Pretax profit (RMm)	305.0	145.5	204.1	223.9	242.7
Net profit (RMm)	245.2	113.1	159.7	175.4	190.3
EPS (sen)	39.7	18.3	25.8	28.4	30.8
PER (x)	11.3	24.6	17.4	15.8	14.6
Core net profit (RMm)	245.2	113.1	161.6	175.4	190.3
Core EPS (sen)	39.7	18.3	26.1	28.4	30.8
Core EPS chg (%)	45.0	-53.9	42.9	8.5	8.5
Core PER (x)	11.3	24.6	17.2	15.8	14.6
DPS (sen)	16.0	11.0	11.0	12.0	13.0
Dividend Yield (%)	3.6	2.4	2.4	2.7	2.9
EV/EBITDA (x)	6.9	12.9	9.3	8.6	7.8
Consensus profit (RMm)			165.0	188.1	202.6
Affin/Consensus (x)			1.0	0.9	0.9

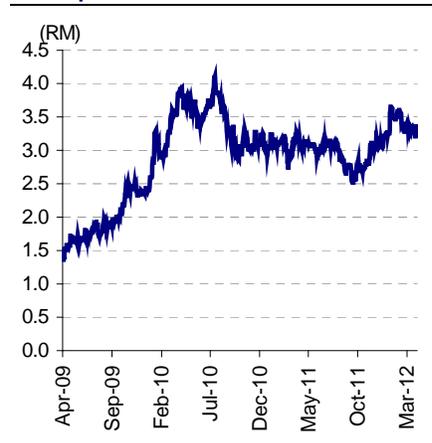
Share price chart



Supermax (BUY, TP: RM2.10)

FYE Dec	2010	2011	2012E	2013E	2014E
Revenue (RMm)	977.3	1,026.9	1,211.0	1,340.1	1,426.0
EBITDA (RMm)	181.5	119.3	142.9	154.6	158.1
Pretax profit (RMm)	183.8	113.0	142.8	157.5	181.0
Net profit (RMm)	158.9	106.1	128.6	141.7	162.9
EPS (sen)	23.4	15.6	18.9	20.8	23.9
PER (x)	8.0	12.0	9.9	9.0	7.9
Core net profit (RMm)	158.9	110.1	128.6	141.7	162.9
Core EPS (sen)	23.4	16.2	18.9	20.8	23.9
Core EPS chg (%)	25.6	-30.7	16.7	10.2	14.9
Core PER (x)	8.0	11.6	9.9	9.0	7.9
DPS (sen)	3.8	3.3	6.0	7.0	8.0
Dividend Yield (%)	2.0	1.7	3.2	3.7	4.3
EV/EBITDA (x)	8.1	12.6	9.6	8.8	8.4
Consensus profit (RMm)			130.7	144.7	170.8
Affin/Consensus (x)			1.0	1.0	1.0

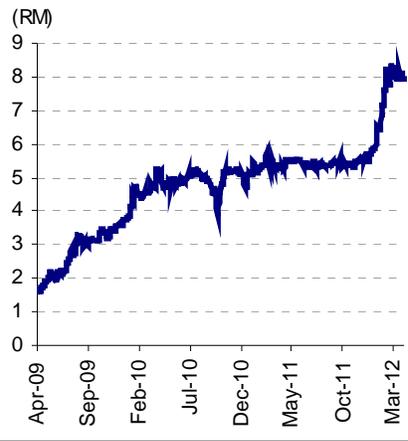
Share price chart



Kossan (ADD, TP: RM3.50)

FYE Dec	2010	2011	2012E	2013E	2014E
Revenue (RMm)	1,046.9	1,092.1	1,275.1	1,354.0	1,454.2
EBITDA (RMm)	182.9	163.4	190.2	213.6	234.1
Pretax profit (RMm)	140.7	116.1	146.5	168.2	189.3
Net profit (RMm)	113.4	91.4	109.3	125.5	137.9
EPS (sen)	35.5	28.6	34.2	39.3	43.1
PER (x)	9.2	11.4	9.5	8.3	7.5
Core net profit (RMm)	113.4	91.4	109.3	125.5	137.9
Core EPS (sen)	35.5	28.6	34.2	39.3	43.1
Core EPS chg (%)	-5.3	-19.4	19.6	14.8	9.9
Core PER (x)	9.2	11.4	9.5	8.3	7.5
DPS (sen)	8.0	7.0	8.0	9.0	10.0
Dividend Yield (%)	2.5	2.2	2.5	2.8	3.1
EV/EBITDA (x)	6.2	6.6	5.4	4.5	3.7
Consensus profit (RMm)			116.5	128.9	135.8
Affin/Consensus (x)			0.9	1.0	1.0

Share price chart



Hartalega (ADD, TP: RM8.05)

FYE Mar	2010	2011	2012E	2013E	2014E
Revenue (RMm)	571.9	734.9	887.1	1,064.6	1,200.2
EBITDA (RMm)	201.0	267.2	293.0	299.8	335.3
Pretax profit (RMm)	177.8	242.8	256.5	269.8	305.0
Net profit (RMm)	142.9	190.3	199.1	212.2	239.9
EPS (sen)	39.3	52.4	54.8	58.4	66.0
PER (x)	20.1	15.1	14.5	13.6	12.0
Core net profit (RMm)	142.9	187.2	205.9	212.2	239.9
Core EPS (sen)	39.3	51.5	56.6	58.4	66.0
Core EPS chg (%)	69.1	31.0	9.9	3.1	13.0
Core PER (x)	20.1	15.4	14.0	13.6	12.0
DPS (sen)	13.3	21.0	25.0	27.0	30.0
Dividend Yield (%)	1.7	2.7	3.2	3.4	3.8
EV/EBITDA (x)	14.2	10.5	9.2	8.7	7.4
Consensus profit (RMm)			206.6	234.4	264.7
Affin/Consensus (x)			1.0	0.9	0.9

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +15% over a 12-month period
TRADING BUY (TR BUY)	Total return is expected to exceed +15% over a 3-month period due to short-term positive development, but fundamentals are not strong enough to warrant a Buy call. This is to cater to investors who are willing to take on higher risks
ADD	Total return is expected to be between 0% to +15% over a 12-month period
REDUCE	Total return is expected to be between 0% to -15% over a 12-month period
TRADING SELL (TR SELL)	Total return is expected to exceed -15% over a 3-month period due to short-term negative development, but fundamentals are strong enough to avoid a Sell call. This is to cater to investors who are willing to take on higher risks
SELL	Total return is expected to be below -15% over a 12-month period
NOT RATED	Affin Investment Bank does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation
OVERWEIGHT	Industry, as defined by the analyst's coverage universe, is expected to outperform the KLCI benchmark over the next 12 months
NEUTRAL	Industry, as defined by the analyst's coverage universe, is expected to perform inline with the KLCI benchmark over the next 12 months
UNDERWEIGHT	Industry, as defined by the analyst's coverage universe is expected to under-perform the KLCI benchmark over the next 12 months

This report is intended for information purposes only and has been prepared by Affin Investment Bank Berhad ("Affin Investment Bank") based on sources believed to be reliable. However, such sources have not been independently verified by Affin Investment Bank, and as such Affin Investment Bank does not give any guarantee, representation or warranty (express or implied) as to the adequacy, accuracy, reliability or completeness of the information and/or opinion provided or rendered in this report. Facts, information, views and/or opinion presented in this report have not been reviewed by, may not reflect information known to, and may present a differing view expressed by other business units within Affin Investment Bank, including investment banking personnel. Reports issued by Affin Investment Bank are prepared in accordance with Affin Investment Bank's policies for managing conflicts of interest arising as a result of publication and distribution of investment research reports. Under no circumstances shall Affin Investment Bank, its associates and/or any person related to it be liable in any manner whatsoever for any consequences (including but are not limited to any direct, indirect or consequential losses, loss of profit and damages) arising from the use of or reliance on the information and/or opinion provided or rendered in this report. Any opinions or estimates in this report are that of Affin Investment Bank as of this date and subject to change without prior notice. Under no circumstances shall this report be construed as an offer to sell or a solicitation of an offer to buy any securities. Affin Investment Bank and/or any of its directors and/or employees may have an interest in the securities mentioned therein. Affin Investment Bank may also make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.

Comments and recommendations stated here rely on the individual opinions of the ones providing these comments and recommendations. These opinions may not fit to your financial status, risk and return preferences and hence an independent evaluation is essential. Investors are advised to independently evaluate particular investments and strategies and to seek independent financial, legal and other advice on the information and/or opinion contained in this report before investing or participating in any of the securities or investment strategies or transactions discussed in this report.

Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

Affin Investment Bank's research, or any portion thereof may not be reprinted, sold or redistributed without the consent of Affin Investment Bank.

Affin Investment Bank is a participant of the Capital Market Development Fund-Bursa Research Scheme, and will receive compensation for the participation.

Affin Investment Bank Bhd (9999-V)
A Participating Organisation of Bursa Malaysia
Securities Bhd

www.affininvestmentbank.com.my
Email : research@affinsecurities.com.my
Tel : 603-2143 8668
Fax : 603-2145 3005