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Wednesday, January 27, 2016

Market Access

Kossan Rubber Industries Berhad

"Consistently Better Off"

We came away from company visit at Kossan Rubber Industries Berhad (Kossan) feeling positive on the company's scheduled expansion plans over the next 5 years including to double the installed capacity from 22 billion pieces p.a. to 44.0 billion pieces p.a.. In view of this steady earnings prospects, the management is confident to keep up the earnings momentum in Q4 FY15, targeting at least RM200 million of full year net profit for FY15, suggesting double-digit growth to the bottom line. Note that we are in the midst of finalizing our new earnings forecast on Kossan and hence, maintain our target price of RM6.84 based on PER of 19x.

Key Highlights

- **Skewing Towards Nitrile Gloves.** To better serve the fast growing demand of synthetic rubber (SR) gloves from developed countries, Kossan is set to achieve production mix of 80% of nitrile glove vs. 20% for natural rubber (NR) glove by 2017 compared to the existing mix of 68:32. This will place Kossan in a strong position to compete in the nitrile glove market after having >36 billion pieces p.a capacity thanks to its massive capacity expansion plan by FY20.

- **Cautious Hedging Practice.** Kossan has employed natural hedge on significant portion of total costs to withstand the inverse impact caused by high volatility in the forex rate. Active hedging (with no longer than 1.5 months) is one of the reasons of its steady EBITDA and PATMI margins of around 20% and 12% level, respectively.

- **Continuous Investing in R&D.** As the glove industry is eyeing lighter weight gloves which subsequently leading to faster production speed and better margins, Kossan is

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SELL (TP: RM6.84)

Current Price (RM)	RM8.31
New Target Price (RM)	TBC
Previous Target Price (RM)	RM 6.84
Previous Recomm.	HOLD
Upside to the Fair Value	-17%
Dividend Yield	1.2%

Stock Code

Bloomberg	KRI MK

Stock & Market Data

Listing		MAIN MARKET
Sector		Glove
Shariah Compliance		Yes
Issued Shares		639.5mn
Market Cap		5,755.2mn
YTD Chg In Share Price		-3.23%
Beta (x)		0.27
52-week Hi/Lo (RM)	6.15	3.48
3M Average Volume (shares)		1.7mn
Estimated Free Float		45.8%

Major Shareholders

Kossan Holdings Sdn Bhd	51.1%
Employees Provident Fund	7.9%
Invesco Ltd	5.9%
Kumpulan Wang Persaraan	5.6%

also working on solutions to overcome chemical allergies (also known as Type IV Error) in nitrile gloves. We also learnt that Kossan has developed new powder-free nitrile examination glove with low dermatitis potential, no accelerator chemicals and latex protein, and this will significantly minimize the likelihood of contracting Type I (caused by latex protein) and Type IV allergies, especially on sensitized users. Some other niched products also include polymer-coated glove which provides strong grip for instrument/object handling in dry/wet conditions. The unique in-house R&D capability symbolizes its main driver to differentiate Kossan among its peers in this extremely competitive environment.

- **Target to Double Up Capacity by 2020.** After the capacity expansion in June-2013 that saw production capacity lifted from 16 billion pieces to 22 billion pieces p.a (+38%), Kossan is set to double its production capacity by another 22.7 billion to 44 billion pieces p.a in the next 5 years, of which 7.4 billion pieces of new capacity to be installed in FY17. Moving forward, we believe the new facilities are capable to produce minimum 42,000 gloves/hr/line and well absorbed by new orders in view of the strong 8-10% annual growth in world's glove demand. The overall utilization rate is expected to stay on average at 85% level, in line with its peers.

New lines	Added Capacity (billion pcs p.a)	Time Frame
8	2.7	2015-2017
12	4	2016-2018
24	8	2017-2018
24	8	2018-2020
68	22.7	
Existing capacity	22	2015
	44.7	By 2020

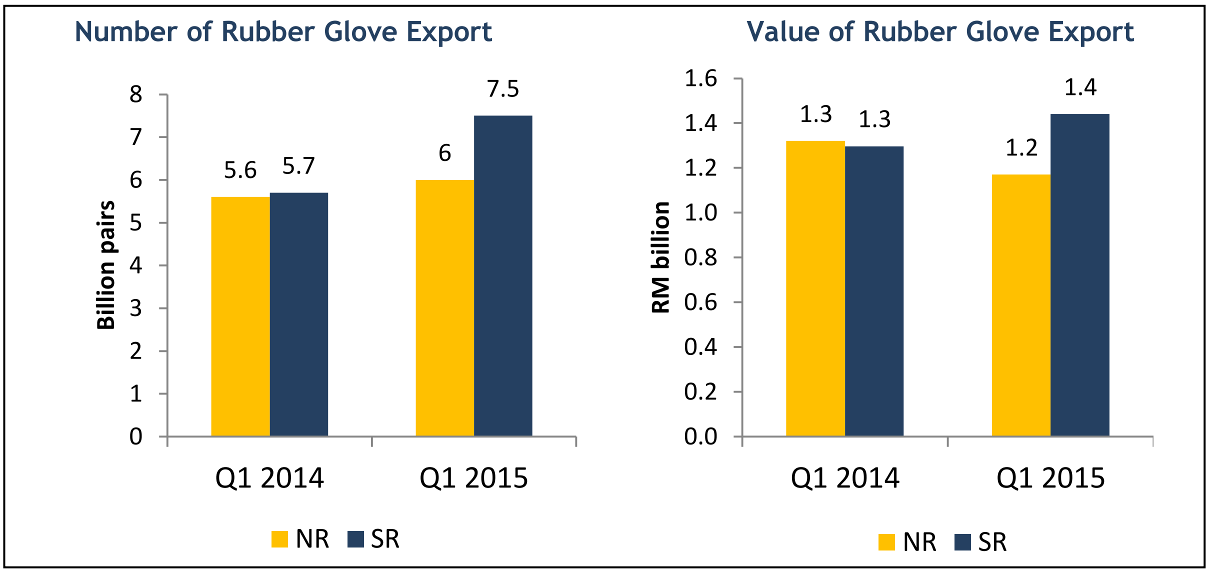
Source: Company, M&A Securities

- **Healthy Gearing Ratio.** We understand that Kossan is spending minimum RM150 million capex per annum for expansion plans in the next 5 years to double its current production capacity of 22 billion pieces per year. Funding is not an issue for Kossan as we have seen the gearing ratio reduced over the years from FY12 (14%) to 9M FY15 (8%). The management anticipates a payback period of no longer than 4 years for the capex spent.

- **More Generous Dividend Payouts.** The consistency of achieving better results over the quarters has seen Kossan's war chest piling up more than RM600 million retained earnings as at 3Q FY15. We are sanguine about a revision of dividend policy to take place within 2 years' time, expecting a payout ratio of 40-50% as opposed to the current 30%.

- **Growing Demand in synthetic glove.** Increasing supply of gloves will continue to fill up global demand which is expected to grow at approximately 10% per annum from 180 billion pieces in 2015. According to Malaysia's Export of Rubber Gloves (MREPC), the export of SR has taken over NR in 1Q 2015, making up SR:NR ratio of 56:44, comparing to 1Q 2014 of 50:50. The robust demand in rubber gloves was revealed in the total exported gloves which grew from 11.3 billion to 13.5 billion pairs (+20% yoy) in the first quarter of 2015 equating to 33% jump in SR export and 7%

increase for NR. Hence, we are not perturbed about the potential oversupply of medical glove owing to its inelastic demand and expect SR to continue leading Malaysia's export of rubber gloves in the coming years as all major glove players have been ramping up production capacity and focus on nitrile gloves manufacturing including Kossan.



Source: MREPC, M&A Securities

- **Valuation & Recommendation.** We are currently in the midst of changing our earnings projections on Kossan. However, we are generally upbeat on the performance of glove makers and confident of the reasonably bright future in Kossan for three reasons: 1) progressive expansion plans in the next 5 years to further penetrate into nitrile glove markets; 2) strong double-digit growth in the export of Malaysia's synthetic glove; 3) improving product quality in high-end surgical gloves and introducing new products to overcome chemical allergies caused by nitrile gloves via continuous R&D and innovation initiatives. Kossan is a **SELL** at this juncture based on the previous TP.

Table 1: Financial Forecast

YE: March (RM million)	FY13	FY14	FY15*	FY16F*	FY17F*
Revenue	1307	1299	1,688	1,921	2,126
EBIT	182	188	284	323	372
Pretax Profit	180	186	265	311	362
Net Profit	140	147	203	241	280
EPS	21	23	32	38	44
PBT Margin	14	14	16	16%	17%
PAT Margin	11	11	12	13%	13%
PER	41	39	28	28	24
P/BV	8	7	6	6	5

Source: Bursa Malaysia, M&A Securities
**We are yet to finalize our projection for FY15,16,17 and we are employing market consensus for now until the upcoming re-initiating coverage report*

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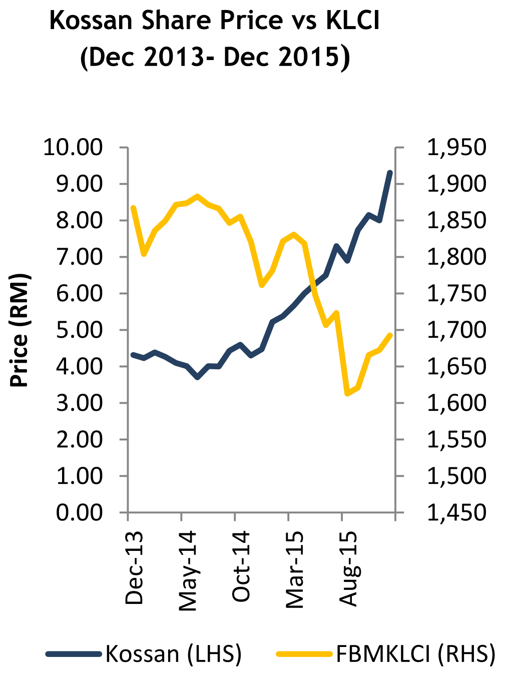
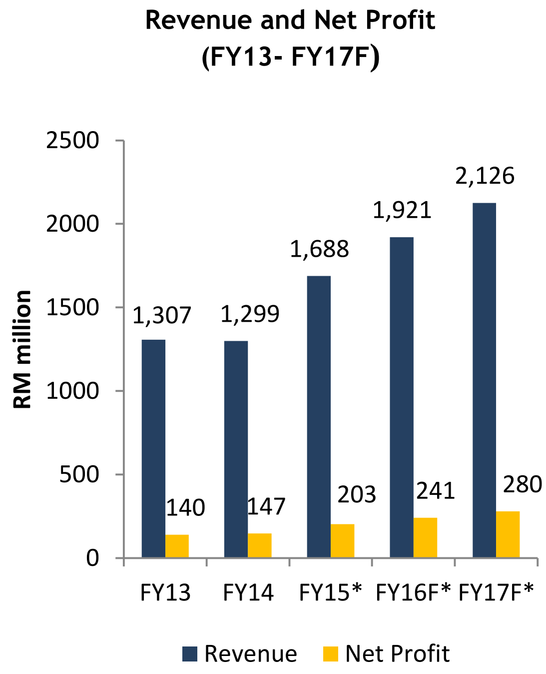
Table 2: Peers comparison

Company	Year Ended	Price (RM)	EPS (sen)		P/E (X)		P/B (X)		ROE (%)	Div Yield (%)	Previous Target Price	Call**
			FY15*	FY16*	FY15*	FY16*	FY15*	FY16*				
Kossan	Dec	8.31	29	38	20	23	5	5	22	2	6.84	TBC
Hartalega	Mar	5.95	14	20	32	29	3	7	18	2	7.98	TBC
Top Glove	Aug	6.40	58	67	17	21	3	5	23	3	6.46	TBC
Supermax	Dec	3.24	16	20	12	17	1	2	11	3	2.28	TBC
Average												

Source: Bloomberg, M&A Securities
**The consensus*
***Not applicable until the release of our re-initiation report*





Source: Bloomberg, M&A Securities

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STOCK RECOMMENDATIONS

BUY	*Share price is expected to be ≥+10% over the next 12 months.*
TRADING BUY	*Share price is expected to be ≥+10% within 3-months due to positive newsflow.*
HOLD	*Share price is expected to be between -10% and +10% over the next 12 months.*
SELL	*Share price is expected to be ≥-10% over the next 12 months.*

SECTOR RECOMMENDATIONS

OVERWEIGHT	*The sector is expected to outperform the FBM KLCI over the next 12 months.*
NEUTRAL	*The sector is expected to perform in line with the FBM KLCI over the next 12 months.*
UNDERWEIGHT	*The sector is expected to underperform the FBM KLCI over the next 12 months.*

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