Securities

AFFIN HWANG CAPITAL

Out think. Out perform.

Eroding premium

Hartalega's FY16 net profit grew 22.9% yoy but missed expectations, as margins were affected by lower ASPs. The Ringgit rally, higher raw materials prices and heightened competition led to the earnings drop in 4QFY16. We believe Hartalega's superior profitability profile is under threat in light of eroding price premiums due to price competition. Maintain HOLD with a lower TP of RM4.00.

4QFY16 revenue up 31.2% yoy

Hartalega's 4QFY16 revenue grew 31.2% yoy and 0.6% qoq to RM400.4m, mainly led by higher sales volume from new capacity added during the quarter. The sales mix was nitrile-heavy at 94%, while total sales volume during the quarter grew 32.2% yoy and 9.1% qoq. The increase in sales volume was offset by the strengthening of the Ringgit against the USD, which gained 2.1% qoq. Production capacity rose to 19.4bn pieces, with a utilisation rate of 81% over 69 lines.

4QFY16 net profit declines 15.3% qoq

4QFY16 net profit grew 12.0% yoy but declined 15.3% qoq to RM61.7m. The EBITDA margin contracted by 4.5ppts qoq and the EBIT margin contracted by 5.2ppts qoq, mainly due to lower ASP, higher raw material prices and the gas hike earlier this year. The ASP declined 16.8% qoq and 24.8% yoy on the capacity influx and heightened competition, especially in the nitrile glove segment. Overall, the FY16 results missed expectations, making up 93% of our estimate and 94% of consensus.

Valuation premium eroding

Hartalega has traditionally enjoyed a valuation premium, predominantly due to: (i) its leadership position in the nitrile gloves segment; and (ii) higher profitability margins. However, we remain unconvinced that the ASP decline (in USD terms) can be reversed or margins can remain intact. Efficiency gains should be limited, as we expect some start-up losses at its NGC. The utilisation rate fell from a peak of 90% to 81% in FY16 due to ongoing line installation. While the capacity addition should sustain net profit growth in absolute terms, we expect Hartalega's margins will continue to trend down amid ongoing ASP adjustments.

Maintain HOLD with lower TP of RM4.00

We cut our earnings by 12% for FY17E and 19% for FY18E on adjustments to our capacity and ASP assumptions. We lower our 12-month target price to RM4.00 (from RM4.90) on a lower target PER of 22x (from 26x), or 1SD below its past-3-year mean PER on CY17E EPS. Our PER reduction is premised on: (i) an eroding valuation premium vis-à-vis peers; and (ii) a declining profitability profile due to price competition.

Earnings & Valuation Summary

FYE Mar (RM'm)	2015A	2016A	2017E	2018E	2019E
Revenue (RMm)	1,146.0	1,498.3	1,685.0	1,901.9	2,114.4
EBITDA (RMm)	322.2	388.4	438.4	480.6	518.4
Pretax profit (RMm)	276.8	317.4	353.0	385.6	413.7
Net profit (RMm)	209.6	257.6	281.9	308.0	330.5
EPS (sen)	12.8	15.7	17.2	18.8	20.1
PER (x)	36.8	29.9	27.4	25.0	23.3
Core net profit (RMm)	209.6	257.6	281.9	308.0	330.5
Core EPS (sen)	12.8	15.7	17.2	18.8	20.1
Core EPS chg (%)	(10.0)	22.9	9.4	9.3	7.3
Core PER (x)	36.8	29.9	27.4	25.0	23.3
DPS (sen)	6.4	6.3	6.9	7.5	8.1
Dividend Yield (%)	1.4	1.3	1.5	1.6	1.7
EV/EBITDA (x)	23.7	20.1	18.1	16.7	15.7
Chg in EPS (%)			(12.1)	(19.3)	-
Affin/Consensus (x)			0.9	0.9	0.6

Source: Company, Affin Hwang estimates

Results Note

Hartalega

HART MK

Sector: Rubber Products

RM4.14 @ 3 May 2016

HOLD (maintain)

Downside: 3.4%

Price Target: RM4.00

Previous Target: RM4.90

Price Performance

	1M	3M	12M
Absolute	-11.0%	-23.5%	+1.5%
Rel to KLCI	-7.8%	-23.4%	+11.7%

Stock Data

Issued shares (m)	1,641.9
Mkt cap (RMm)/(US$m)	6,793.9/1,728.2
Avg daily vol - 6mth (m)	2.5
52-wk range (RM)	3.85-6.15
Est free float	28.6%
BV per share (RM)	0.89
P/BV (x)	4.63
Net cash/ (debt) (RMm) (3QFY16)	(99.1)
ROE (2017E)	17.7%
Derivatives	Nil
Shariah Compliant	Yes

Key Shareholders

Hartalega Industries	49.3%
EPF	7.5%
Budi Tenggara	3.0%

Source: Affin Hwang, Bloomberg

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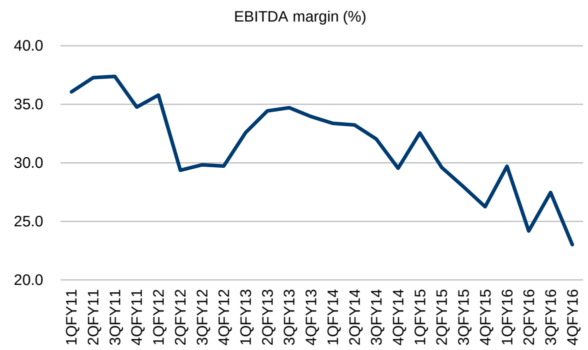
Margins under pressure

Hartalega's declining ASP continues to crimp margins on the capacity influx and heightened competition in the nitrile segment. We had previously highlighted that Hartalega is most vulnerable to price competition *(See: Stretched year ahead)*. Hartalega's nitrile gloves, which have been priced at a premium due to superior quality, have seen downward adjustments to ASP in recent quarters. Competition has narrowed the quality gap with lower pricing, especially in the mass market nitrile glove segment where Hartalega has a strong foothold. This forced Hartalega to drop pricing in a bid to protect market share, which had a knock-on impact on margins. This resulted in the decline of Hartalega's EBITDA margins from highs of 34-37% in 2011 to 26% in FY16.

Declining ASP trend to continue

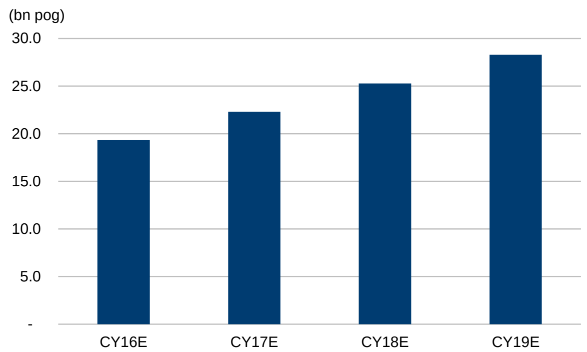
We believe declining ASP trend is here to stay in the near term, at least for mass market nitrile gloves. The influx of nitrile glove capacity has effectively eroded Hartalega's pricing power. As of last check, Hartalega's ASP is still higher than the market's going rate, suggesting a narrowing gap. Notwithstanding aggressive expansion plans in the industry as a whole, the full commissioning of 2 new plants (+9.5bn pieces of gloves) in NGC this year should exert some pressure on the ASP as Hartalega prioritises filling up new capacity at the expense of lower ASP and margins to offset depreciation costs. Management has already put in place mitigating measures to better manage supply-demand dynamics by delaying Plant 3 and Plant 4 commissioning by 3 months (previously two) while the line installation is due to slow to two lines every 1.5 months (previously one month).

Fig 1: Hartalega: EBITDA margin trending down



Source: Affin Hwang, Company

Fig 2: Hartalega: capacity expansion plans



Source: Affin Hwang, Company

Fig 3: Results Comparison

FYE Mar (RMm)	4QFY16	QoQ % chg	YoY % chg	FY16	YoY % chg	Comments
Revenue	400.4	0.6	31.2	1,498.3	30.7	Revenue lifted by increase in sales volume from new capacity increase
Op costs	(308.3)	6.8	37.0	(1,109.9)	36.5	Higher operating costs due to spike in raw material prices and gas hike this year
EBITDA	92.1	(15.7)	15.0	388.4	16.8	
EBITDA margin (%)	*23.0*	*-4.5ppts*	*-3.2ppts*	*25.9*	*-3.1ppts*	
Depn and amort	(21.1)	18.4	65.8	(70.6)	27.1	Higher depreciation charges from new line installation
EBIT	71.1	(22.4)	5.5	317.7	14.7	
EBIT margin (%)	*17.7*	*-5.2ppts*	*-4.3ppts*	*21.2*	*-3.0ppts*	Lower operating margins due to pricing pressure and Ringgit strength
Int expense	0.1	nm	na	0.0	na	
Int and other inc	-	na	na	-	na	
EI	-	na	na	-	na	
Pretax profit	**71.2**	(21.8)	5.6	317.3	14.5	
Core pretax	71.2	(21.8)	5.6	317.3	14.5	
Tax	(9.4)	(48.5)	(23.4)	(59.3)	(11.1)	
Tax rate (%)	*13.2*	*-6.8ppts*	*-5.0ppts*	*18.7*	*-5.4ppts*	Reinvestment allowance tax awarded for construction of NGC
Net profit to company	61.8	(15.1)	12.1	258.0	22.7	
MI	(0.0)	nm	nm	(0.1)	nm	
Net profit	**61.7**	(15.3)	12.0	257.8	22.9	
EPS (sen)	3.8	(15.3)	12.0	15.7	22.9	
Core net profit	**61.7**	(15.3)	12.0	257.8	22.9	Results miss expectations at 93% of our estimate and 94% of consensus

Source: Affin Hwang, Company data

Key risks to our view include: i) a sudden depreciation of the US$ against the RM, ii) a sharp increase in raw material prices, and iii) lesser-than-expected pricing competition among glove players.

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +10% over a 12-month period
HOLD	Total return is expected to be between -5% and +10% over a 12-month period
SELL	Total return is expected to be below -5% over a 12-month period
NOT RATED	Affin Hwang Investment Bank Berhad does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation

The total expected return is defined as the percentage upside/downside to our target price plus the net dividend yield over the next 12 months.

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

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