SECTOR UPDATE

Gloves – Malaysia

4Q22: Upgrade To OVERWEIGHT As Bottom Has Been Sighted

The sector fell into unprecedented losses in 4Q22. Sector losses are expected to continue but bottom out in 1H23. Alongside improving ASP outlook and moderating costs, corporate losses should be narrow in 2H23. Meanwhile, valuations are trading close to +1SD to merely recovering 2024 earnings, suggesting deep value when 2025 earnings are taken into perspective. Given the favourable reward-to-risk payoff, we upgrade the sector to OVERWEIGHT.

WHAT'S NEW

- **Worst is over for ASPs?** Over the recent quarter, the Malaysia glove producers indicated an ASP revision heading into 2Q23. Top Glove is looking at an ASP in the region of US$21/'000 pieces or a >20% hike. This is against the backdrop of unsustainable ASPs with producers operating at a loss, rising input cost (energy, wage cost and raw material prices) and depleting customers' inventory levels. The ASP revision is positive as that alongside an expected softening of input cost in 2H23 could see corporate losses minimised. Going into 2024, we assume an ASP of USD24/'000 pieces.

- **Lockstep adjustment by China producers as well but possesses cost advantage.** Positively, China glove producers are said to have mirrored the revision, re-pricing their gloves to USD17/'000 pieces from USD14/'000 pieces. Notably, the ASP discount to the Malaysia producers' ASP remains unchanged. The China producers' cost advantage over their Malaysia peers is due to the cheaper but less environmentally-friendly coal as an energy source as opposed to natural gas. The acute cost advantage translates to almost 10% cheaper ASPs. However, with natural gas tariffs in Malaysia expected to decline from Apr 23, it could narrow the fuel cost advantage and consequently, narrow the China producers' ASP differential to 5% in 2H22.

ACTION

- **Upgrade to OVERWEIGHT.** Recent results have succumbed to margin pressure, registering unprecedented corporate losses across the sector. However, we expect earnings to bottom out in 1H23 (even dipping below expectations) but ASPs are due to finally see a positive and meaningful adjustment across competing regional producers as well. In addition, with costs expected to moderate in 2H23, we expect losses to narrow. Meanwhile, valuations are trading close to +1SD to merely recovering 2024 earnings, suggesting deep value when 2025 earnings are taken into perspective. As a result, we opt to roll over our valuations to a profitable 2024 for Kossan and Hartalega (have done so for Top Glove) and peg earnings to five-year mean valuations. **We also take the opportunity to upgrade both to BUY**.

- Given the backdrop of improving fundamentals and a medium-term view of bargain valuations, the reward-to-risk payoff appears favourable. Hence, we upgrade the sector to OVERWEIGHT from MARKET WEIGHT. Our top pick for the sector is Hartalega for its above industry operating efficiency and relative upside versus its peers.

OVERWEIGHT

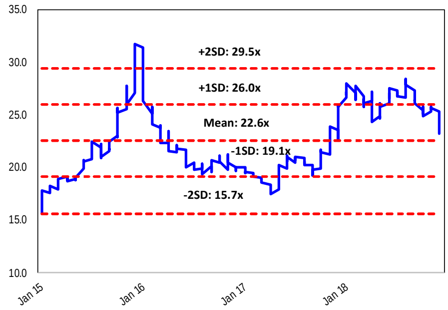
(Upgraded)

TARGET PRICE DERIVATION

		PE peg (x)		Target price (RM)
Top Glove	2024	29	+1.5 SD	0.95
	2025	20	Mean	1.34
Hartalega	2024	28	Mean	2.15
	2025	25	-0.5 SD	2.85
Kossan	2024	24	Mean	1.42
	2025	24	Mean	1.86

Source: UOB Kay Hian

SECTOR GLOVE VALUATIONS (PRE-COVID-19)



Source: Bloomberg

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PEER COMPARISON

Company	Ticker	Rec	Price @ 20 Mar 23 (lcy)	Target Price (lcy)	Mkt Cap (US$m)	PE (x) FY23F	PE (x) FY24F	EV/EBITDA (x) FY23F	EV/EBITDA (x) FY24F	P/B (x) FY23F	Div Yield (%) FY23F
Malaysia											
Top Glove	TOPG MK	BUY	0.91	0.95	1,633.1	-17.8	52.3	-45.8	14.3	1.4	0.0
Hartalega	HART MK	BUY	1.92	2.15	1,447.3	192.3	54.9	20.1	13.0	1.3	0.4
Kossan	KRI MK	BUY	1.23	1.42	693.9	74.5	20.6	14.0	5.9	0.8	0.5
Supermax*	SUCB MK	N.R.	0.90	-	515.8	31.8	18.6	-0.7	-0.2	0.5	0.5
Malaysia avg.					1,072.5	70.2	36.6	-3.1	8.3	1.0	0.3
Regional											
Intco Medical	300677 CH	N.R.	24.19	-	2,325.1	25.0	13.4	10.4	6.1	1.0	nm
Sri Trang Gloves	STGT TB	N.R.	10.40	-	867.0	28.6	17.5	8.2	6.2	0.8	4.7
Riverstone	RSTON SP	N.R.	0.53	-	613.6	3.3	3.0	4.5	4.0	0.4	nm
Regional avg.					1,268.6	19.0	11.3	7.7	5.4	0.7	4.7
Average					1,156.5	40.3	23.8	-2.4	6.8	0.9	1.4

** Restricted list. Financials are based on consensus projections.*
Source: Bloomberg, UOB Kay Hian

- **Inflection point in 2H23?** The potential narrowing of ASP differential between glove producers in Malaysia to those in China and Thailand (Sri Trang Gloves) in 2H23 could be an inflection point to volume demand shifting back to Malaysia. The Malaysia glove producers' utilisation rates are close to 40% vis-à-vis 50-60% of their regional peers. Apart from the shift in demand, utilisation rates should improve from an overall gradual recovery in demand from the diminishing excess inventory and industry consolidation.

- **Excess inventory.** It is estimated that 131b pieces of glove purchases during the pandemic (2020-21) were in excess of the usage rate. On top of that, with surplus industry capacity, orderbook visibility has shortened to 20 days from 40 days pre-pandemic. Given the abundance in excess inventory (131b pieces, which accounts for up to one-third of 2023's global glove demand). That said, replenishment activity has been emerging. Overall, we opine that excess inventory may be completely exhausted by 2024-25. That should coincide with industry utilisation rates returning to optimal levels of 80-90%.

- **Industry consolidation emerging.** There are emerging signs of an industry consolidation such as: a) new entrants into the industry during the pandemic and smaller producers such as Aspen Group (ASPEN SP, NR) and VIP Gloves (VIP AU, NR) having exited the industry, b) established incumbent producers retiring less efficient and aged production lines, and c) smaller producer Careplus (CPG MK, NR) disposing of a 50% stake in its subsidiary. Granted, although the exiting capacity is minimal, it still signals a bottoming out of the industry. That said, with industry utilisation rates at around 40%, it may well take more than a year before demand-supply reaches equilibrium.

- **Sector earnings contraction expected to bottom out in 1H23.** We expect sector earnings to decline to a loss of -RM92m in 2023 from RM1.01b in 2022. This should be followed by a recovery in earnings to RM655m in 2024. We expect quarterly earnings to bottom out in 1Q-2Q23. This is against the backdrop of higher energy cost (natural gas and electricity) and rising raw material cost. 2H23 should realise higher ASPs and moderating cost across natural gas tariffs and raw materials that could restore some glove companies to breakeven. We then expect ASPs to gradually improve further alongside utilisation rates to drive 2024's earnings. Our resulting 2023-24 PAT margin assumption of -1.2%/5.9% appears reasonable when compared to the three-year pre-pandemic (2017-19) PAR margin average of 11.9%.

- **Valuations should moderate significantly as earnings recover off a low base.** Existing sector PE valuations to 2023 are negligible as sector earnings are contracting. Sector is however trading at 25.9x to 2024 earnings. This is at +1SD of the sector's pre-pandemic five-year mean. Valuations only appear lofty as they are against all-time depressed down-cycle earnings. A subsequent rollover in valuations to 2025 earnings pegged to below mean valuations still suggests sufficient upside going forward. This should coincide with sector fundamentals improving further.

ESSENTIALS

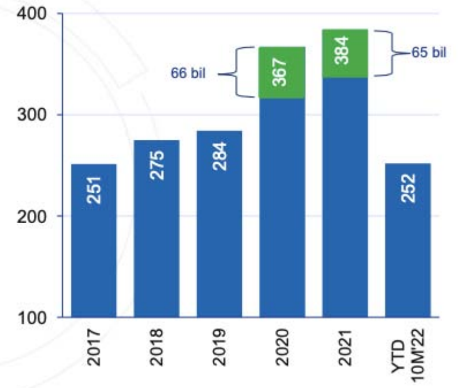
- **4Q22 results round-up.** Sector earnings came in well below expectations. Margins were squeezed by softer ASPs and higher natural gas tariffs. On average, the Big 3 (Top Glove, Hartalega and Kossan) saw ASPs declining 9.5% while volume sales contracted 3.3%. Both volume and ASPs continue to be hampered by industry capacity surplus and excess inventory across the supply chain. As a result, the sector's top-line contracted 26.5% qoq. Off lower margins and scale, sector's operational earnings marginally fell into losses (-12.3%) while PAT dipped to unforeseen losses (-RM313m) or -24.3%.

4Q22 SECTOR RESULTS SNAPSHOT

(RMm)	4Q20	3Q21	4Q21	qoq % chg	yoy % chg
Revenue	4037.6	2383.2	1750.5	-26.5	-56.6
EBITDA	1096.5	173.9	-108.6	-162.5	-109.9
Net profit	711.3	3.6	-313.0	-8726.8	-144.0
				qoq ppt chg	yoy ppt chg
EBITDA margin (%)	27.5	9.0	-12.3	-21.3	-39.8
Kossan	32.8	10.8	7.1	-3.7	-25.7
Hartalega	38.9	13.6	2.7	-10.9	-36.3
Supermax	19.3	11.2	-47.4	-58.6	-66.7
Top Glove	19.0	0.6	-11.4	-12.1	-30.4
Net margin	17.6	1.4	-24.3	-25.7	-41.9

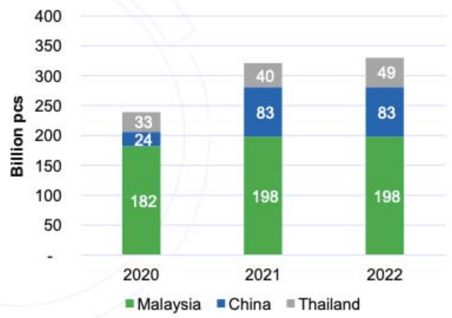
Source: Respective companies, UOB Kay Hian

GLOBAL DEMAND FOR GLOVES (B)



Highlighted in green: estimated excess purchases of 131b pieces
Source: International Trade Center, Hartalega

ESTIMATED INDUSTRY SUPPLY – KEY PLAYERS



Source: Hartalega

4Q22 NET PROFIT

Company	4Q22 (RMm)	qoq % chg	yoy % chg	Results
Kossan	-2.5	-111	-101	Below
Hartalega	-31.9	-212	-112	Below
Supermax*	-110.4	nm	-331	Below
Top Glove	-168.2	-220	-191	Below
Total	-313.0	nm	-144	

Source: Bloomberg, UOB Kay Hian
**Restricted list. Expectations are derived from consensus projections.*

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