

BETTER YEAR AHEAD EXPECTED FOR RUBBER PRODUCT SECTOR

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Maintain neutral: We expect the industry supply-demand dynamics to be well balanced going into 2017, as staggered expansion and timing delays in new capacity commissioning will allow for better demand absorption.

The US dollar average selling price (ASP) is expected to remain stable with an upward bias on the back of moderating pricing pressure. Volume sales growth will be the key earnings driver to look out for, while improving efficiency should negate rising production costs.

We retain the sector at “neutral”, largely to account for the rich valuation at 19 times 2017 earnings per share (EPS). We favour Top Glove Corp Bhd for its strong volume growth characteristics, changing product mix and decent valuations. It is our top pick and only “buy” call.

Contrary to the consensus view, we expect an overall improved operating environment in 2017, on the back of capacity discipline by glove manufacturers and well matched growing glove consumption on rising healthcare awareness.

We estimate the top three glove manufacturers (Top Glove, Hartalega Holdings Bhd and Kossan Rubber Industries Bhd) to commission up to 5.7 billion gloves in capacity net adds in 2017, after taking into account the staggered expansion and timing delays.

Global glove demand is projected at 11.4 billion net adds, based on an estimated 6% to 8% annual growth, which is at least double that of the top three supply growth. This should promote healthy demand absorption while minimising pricing volatility, in our view.

That aside, tailwinds from the ringgit weakness will continue to benefit the industry on a stable US dollar ASP outlook, by boosting Malaysia's pricing competitiveness in keeping utilisation high and sustaining market share gains.

Rising raw material prices are a cause for concern, as it constitutes at least 50% of total production costs. Nonetheless, the high acreage of rubber plantations maturing should keep a lid on rising prices with higher supply in 2017.

We project the natural rubber price to average at RM5 to RM5.50 per kg in 2017, significantly lower than the last close of RM6.46. The recent Bank Negara Malaysia ruling to convert 75% of US dollar proceeds is a non-event, and largely an administrative nightmare.

The levy on foreign workers will be an additional cost to manufacturers, but is well contained with only a 3% impact on sector earnings.

Rising production costs remain a perennial issue, but improving efficiencies and growing automation should buffer the unrelenting cost pressure at the very least, keeping margins in check.

2017 is shaping up to be a recovery year for glove manufacturers after a whirlwind 2016. With a stable US dollar ASP outlook, incremental volume will likely sustain top-line growth, while margin should normalise at a higher level on improving productivity.

We expect Top Glove to be the biggest beneficiary in the event of a US dollar ASP recovery, given its huge production base and 10% volume compound annual growth rate for financial year 2017 to estimated financial year 2019. We reaffirm our “buy” rating for Top Glove, and raise our 12-month TP to RM6.00, pegged to 18 times 2017 EPS. — *Affin Hwang Capital*, Jan 6