TA SECURITIES
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COMPANY UPDATE
Wednesday, October 07, 2015
FBM KLCI: 1,662.51
Sector: Healthcare

Kossan Rubber Industries Berhad

Sailing Through Macroeconomic Headwinds

TP: RM9.00 *(+13.8%)*

Last traded: RM7.91

BUY

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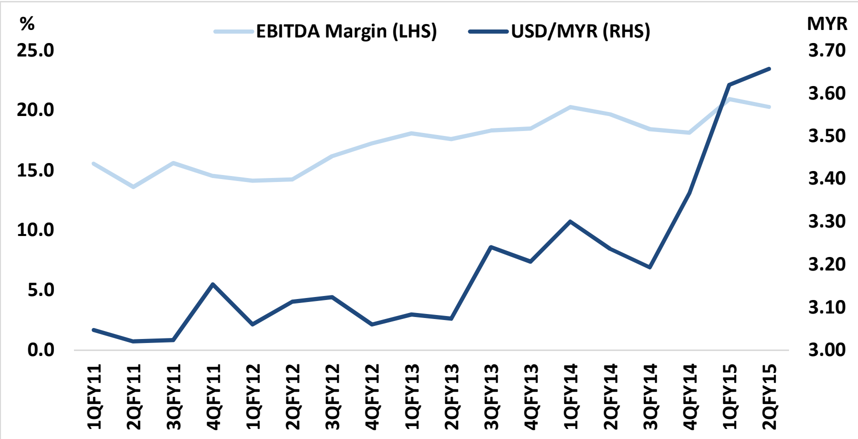
We recently met with Kossan's management to get updated on its operations. Below are the key takeaways:

Higher Volumes Offset Fall in ASP

The rally in the USD against the MYR (+33.6% YoY) and environment of subdued latex and nitrile prices have shed light on the profitability of the local gloves industry. Notwithstanding the fact that these are positive factors, we believe that their impact on Kossan's margins have been close to negligible as glove manufacturers have been compelled into reducing prices to share cost savings with customers in order to maintain competitiveness. We note that despite stronger USD/MYR over 1HFY15 - where it appreciated by 13.0% YoY, Kossan's EBITDA margin growth remained relatively stable, improving at an average pace of only 0.3%-points per quarter from 2011 to 2014.

Figure 1 : EBITDA Margins vs. USD/MYR (2011-2014)



Source: Company, TA Securities

Despite the downward pressure on ASPs, the group continued to fare well as it displayed overall margin improvements while registering top line and bottom line growth. For 1HFY15, its revenue and net profit grew by 23.8% YoY and 30.1% YoY respectively while PAT margins increased by 0.6-% points YoY. The strong performance observed was largely underpinned by the: 1) higher volume of gloves sold (+36.0% YoY) supported by contributions from its newly commissioned plants (Plant 1), 2) better focused product mix (NR:SR of 32:68 in 1HFY15 vs. 43:57 in 1HFY14) and 3) improving operational efficiency.

Listing	Main Market
Share Cap (mn)	639.5
Market Cap (RMmn)	5,058.2
Par Value	0.50
52-wk Hi/Lo (RM)	7.96/4.21
12-mth Avg Daily Vol ('000 shrs)	881.0
Estimated Free Float (%)	31.0
Beta	0.32
Major Shareholders (%)	
	Kossan Holdings Sdn Bhd - 51.06
	EPF - 8.20
	Invesco Ltd - 6.52
	KWAP - 5.58

Forecast Revision

	FY15	FY16
Forecast Revision (%)	-	-
Net profit (RMm)	202.0	230.0
Consensus	204.5	234.7
TA's / Consensus (%)	98.8	98.0
Previous Rating	Buy (Maintained)	

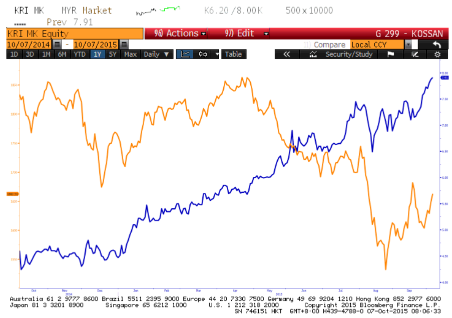
Financial Indicators

	FY15	FY16
Net gearing (x)	0.1	0.1
CFPS (RM)	33.3	41.0
P/CFPS (x)	21.9	17.8
ROAA (%)	14.6	14.8
ROAE (%)	22.8	22.8
NTA/Share (RM)	1.4	1.6
Price/ NTA (x)	5.1	4.5

Share Performance (%)

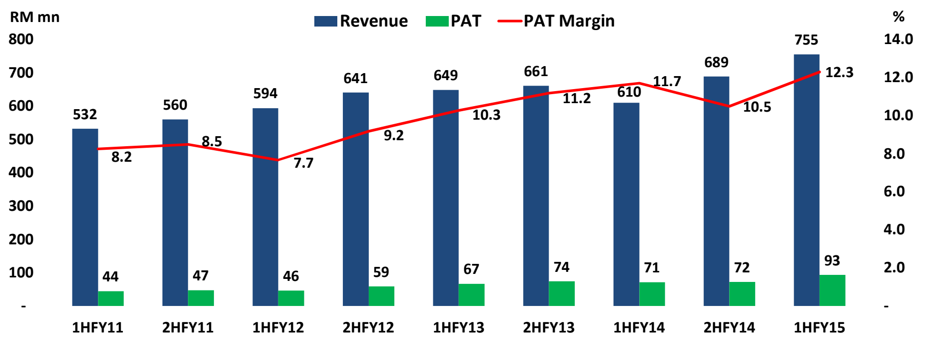
Price Change	KRI	FBM KLCI
1 mth	8.7	4.6
3 mth	21.9	(3.2)
6 mth	35.2	(9.8)
12 mth	72.0	(9.7)

(12-Mth) **Share Price** relative to the **FBM KLCI**



Source: Bloomberg

Figure 2 : Revenue and PAT (2011-2015)



Source: Company, TA Securities

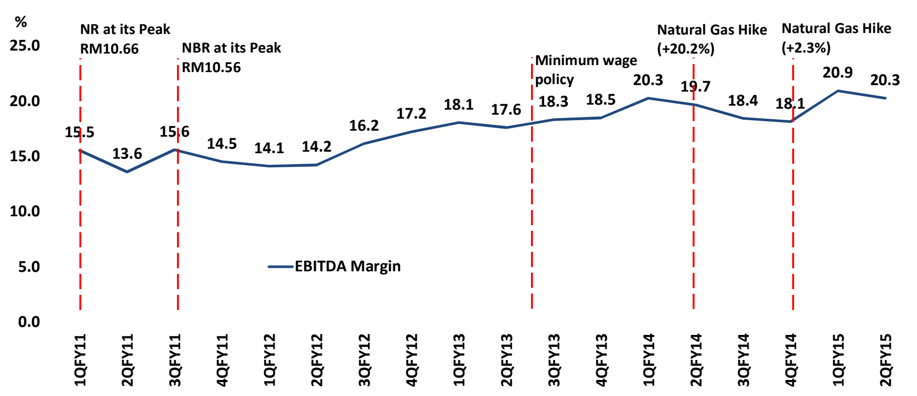
Efficiency and Innovation Pays Off

Rather than being driven by favourable macroeconomic factors, we believe that the recent improvement in margins can to a large extent be attributed to the concerted efforts the group has been placing on production process optimization (efficiency) and research and development (R&D) in chemical and mechanical technology. These complementing efforts have allowed the group to innovate better quality and unique products at lower costs and competitive prices. It also increased its competitive advantage as some products are difficult for competitors to imitate. We view that the strong take-up it received for its new capacity from Plant 2 & 3 attests to these efforts. Capacities from both these plants have already been fully taken up. Furthermore, to date, there are still substantial orders which it has not been able to cater for not until the completion of new expansion.

To emphasise, management shared the extensive scope for cost savings. For instance, the group's capability in manufacturing quality and competitively priced products has enabled it to build customer loyalty and secure a steady flow of orders. This has made it operationally viable to dedicate specific production lines to these customers. Consequently, production lines are able to run smoothly with minimal interruptions during manufacturing. Coupled with its efficiently designed lines, higher productivity has been achieved through lesser downtimes, wastage and rejection rates. All in, these have contributed to a reduction in overall production costs and allowed for the sharing of the cost savings with customers.

Reflecting on these efforts, amid the various cost pressures glove manufacturers have been confronted with - escalating labour costs (minimum wage policy), increasing energy costs (natural gas and electricity), and fluctuating raw material prices (NR and NBR) – the group has seen decent margin improvement in recent years.

Figure 3 : EBITDA Margins (2011-2015)



Source: Companies, TA Securities

Prudent Expansion Plans

Since embarking on its expansion programme in June 2013, the group has completed the construction of 3 new nitrile plants (Plant 1, Plant 2 and Plant 3). These plants collectively house a capacity of 6.0bn gloves/annum and have enlarged existing production capacity to 22.0bn gloves/annum. Plant 1 (+2.0bn gloves/annum) which was fully operation since October 2014 contributed to the strong volume sales observed in 1HFY15. Meanwhile, Plant 2 and Plant 3 (+4.0bn gloves/annum) that were fully operational since June 2015 are expected to contribute positively to 2HFY15 performance with full take up already secured from its customers.

On-going expansion includes the construction of 2 nitrile glove plants in Meru, Klang (+4.5bn gloves/annum). Full commercial production is expected by early 2017 and this will bring total capacity to 26.5bn gloves/annum.

By 2021, production capacity is targeted at 50.0bn gloves/annum. With 70 acres of land bank within the Klang Valley which have a potential capacity of 23.5bn gloves/annum, it will be sufficient to fuel earnings growth in the near to medium term, adding on average +4.7bn gloves/annum over 2017-2021.

Overall, we remain confident on Kossan's growth trajectory given the good reception its new capacities have been receiving from its customers. It also goes to show that: 1) it possesses a competitive edge in the gloves industry and 2) the gloves industry is still thriving. Adding comfort to its expansion pace, the group also has a prudent expansion approach whereby it will only stage expansion when utilization rates at its existing plants reach 85%.

Table 1 : Glove Capacity Expansion Plans

	Land Size	Capacity (pcs p.a.)	Timeframe (Tentative)
Existing capacity:		22.0bn	
Planned expansion:			
Meru, Klang	15 acres	4.5bn	2015 - 2017
Meru, Klang	13 acres	1.0bn	2016 - 2018
Batang Berjuntai	57 acres	22.5bn	2016 - 2020
Total Capacity by Dec 2021		**50.0bn**	

Source: Companies, TA Securities

Recommendation

Our TP for Kossan remains unchanged at RM9.00/share. The commendable efforts placed on efficiency and innovation have clearly been quantified in the sustained margin improvements observed over the past years. In the near term, we are positive on the group's earnings growth prospects with increased contributions stemming from its newly commissioned nitrile plants, Plant 2 and 3 (+4.0bn gloves/annum). For FY15, it is targeting for a NR:SR of 31:69 vs. 43:57 in FY14.

P&L

FYE Dec (RMmn)	FY13	FY14	FY15F	FY16F	FY17F
Revenue	1,307.3	1,301.7	1,802.5	1,996.7	2,333.2
EBITDA	231.9	243.5	337.2	376.5	452.2
Depreciation & amortisation	-51.0	-55.9	-62.0	-65.0	-67.8
Net finance cost	-0.8	-0.9	-7.8	-7.0	-6.3
EI	0.0	0.0	0.0	0.0	0.0
PBT	180.1	186.7	267.4	304.4	378.0
Taxation	-40.1	-37.9	-60.2	-68.5	-85.1
MI	-3.6	-3.2	-5.2	-5.9	-7.3
Net profit	136.4	145.6	202.0	230.0	285.7
Core net profit	136.4	145.6	202.0	230.0	285.7
EPS (sen)	21.3	22.8	31.6	36.0	44.7
DPS (sen)	7.0	8.0	14.2	16.2	20.1

Ratios

FYE Dec (RMmn)	FY13	FY14	FY15F	FY16F	FY17F
Valuations					
PER	34.2	32.0	23.1	20.3	16.3
Dividend yield	1.0	1.1	2.0	2.2	2.8
PBV	6.6	5.8	5.1	4.5	3.9
Profitability ratios					
ROAE	20.4	18.8	22.8	22.8	24.6
ROAA	13.0	12.2	14.6	14.8	16.5
EBITDA margin	17.7	18.7	18.7	18.9	19.4
PBT margin	13.8	14.3	14.8	15.2	16.2
Liquidity ratios					
Current ratio	1.8	1.7	1.7	1.9	2.1
Quick ratio	1.3	1.1	1.1	1.2	1.3
Leverage ratios					
Total liabilities/equity	0.5	0.6	0.6	0.5	0.5
Net debt/equity	0.1	0.2	0.1	0.1	0.0
Int. coverage ratio	235.2	215.1	35.1	44.2	60.6
Growth ratios					
Sales	5.9	-0.4	38.5	10.8	16.9
Pretax	30.1	3.7	43.2	13.9	24.2
Earnings	33.5	6.7	38.8	13.9	24.2
Total assets	11.7	16.6	15.2	9.6	12.2

Balance Sheet

FYE Dec (RMmn)	FY13	FY14	FY15F	FY16F	FY17F
Fixed assets	600.5	724.6	762.6	797.6	829.8
Associates + Subsidiaries	0.0	0.0	0.0	0.0	0.0
Goodwill	4.9	4.9	4.9	4.9	4.9
Others	0.1	0.1	0.1	0.1	0.1
LT assets	605.6	729.7	767.7	802.7	834.9
Inventories	148.8	193.5	270.4	299.5	350.0
Trade receivables	242.9	280.9	360.5	399.3	466.6
Cash	100.6	63.9	65.2	105.2	153.4
Others	8.1	21.7	21.7	21.7	21.7
Current assets	500.4	560.0	717.7	825.7	991.7
Total assets	1,106.0	1,289.7	1,485.4	1,628.4	1,826.6
Trade payables	142.1	170.3	270.4	299.5	350.0
ST borrowings	119.6	142.7	129.8	116.9	105.2
Others	17.1	22.8	22.8	22.8	22.8
Current liabilities	278.7	335.8	423.0	439.1	477.9
LT borrowings	49.4	63.4	55.6	50.1	45.1
Others	55.9	62.5	62.5	62.5	62.5
LT liabilities	105.3	125.9	118.1	112.5	107.5
Share capital	319.7	319.7	319.7	319.7	319.7
Reserves	385.2	487.3	598.4	724.9	882.0
Shareholders' funds	704.9	807.0	918.1	1,044.6	1,201.8
MI	17.1	21.0	26.2	32.1	39.4
Total liabilities and equity	1,106.0	1,289.7	1,485.4	1,628.4	1,826.6

Cash Flow

FYE Dec (RMmn)	FY13	FY14	FY15F	FY16F	FY17F
PBT	180.1	186.7	267.4	304.4	378.0
Depreciation and amortisation	51.0	55.9	62.0	65.0	67.8
Net interest	4.2	5.8	7.8	7.0	6.3
Other non-cash	7.4	-2.5	0.0	0.0	0.0
Changes in WC	5.4	-43.4	-56.4	-38.8	-67.3
Tax paid	-35.2	-37.4	-60.2	-68.5	-85.1
Net interest	-0.8	-0.9	-7.8	-7.0	-6.3
Operational cash flow	212.2	164.4	212.8	262.1	293.5
Capex	-119.8	-141.3	-100.0	-100.0	-100.0
Others	1.0	1.6	0.0	0.0	0.0
Investing cash flow	-118.8	-139.7	-100.0	-100.0	-100.0
Net share issue	0.0	0.0	0.0	0.0	0.0
Dividend paid	-44.7	-44.8	-90.9	-103.5	-128.5
Net change in debts	-48.6	-4.2	-20.6	-18.5	-16.7
Others	0.6	-12.6	0.0	0.0	0.0
Financial cash flow	-92.7	-61.5	-111.5	-122.1	-145.2
Net cash flow	0.7	-36.9	1.3	40.0	48.3
Opening cash flow	99.8	100.6	63.9	65.2	105.2
Forex	0.1	0.2	0.0	0.0	0.0
Closing cash flow	100.6	63.9	65.2	105.2	153.4

for TA SECURITIES HOLDINGS BERHAD(14948-M)

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