Valuation is an art

By PANKAJ C. KUMAR

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Top Glove HQ

Top Glove Corp Bhd (pic) is one of the most widely followed companies among analysts and the market over the past year, especially so since the outbreak of the Covid-19 pandemic.

The company's share price too has seen significant price gains and losses over the past 12 months, and of course, there are many factors that caused the euphoric rally as well as the sell-off that quickly came soon after news of a vaccine broke in November last year. The ups and downs of the stock has also got to do with the market call on the stock, as typically, investors are also driven by the valuation of the company that is made by analysts

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mind-boggling.

Top Glove manufacturing

With a revenue of RM5.36bil, Top Glove chalked up an impressive net profit of RM2.87bil. This is spectacular, given that the company has now broken Bursa Malaysia's record of the highest quarterly net profit by a listed firm, previously held by Maybank, which stood at RM2.45bil for the Q4 period of 2019.

Interestingly, for the first-half (H1) period ended Feb 28, Top Glove's cumulative net profit of RM5.29bil is equivalent to all the profits the company had made between the 2008 and 2020 financial years, with about RM482mil extra to spare.

Despite the majestic results, Top Glove got the brickbats from the investment fraternity in the form of downgrades, both in target price as well as earnings, as the majority of them saw a peak in earnings and expectations are now running high that the average selling price (ASP) is on a downtrend. Nevertheless, the downgrade did not, in most cases, cause brokers to reverse their buy calls, with the exception of one or two broking firms.

Now the tough question: What's next?

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Post-Q2 results, analysts as usual were quick to update the market in terms of their assessment of Top Glove's fundamentals. There are a few key elements that are now playing out in the healthcare industry. Although we are still in the pandemic stage, the emergence of the vaccine for Covid-19, which is now being rolled out aggressively throughout the world, may potentially reduce demand growth for gloves. There is also a counter-argument that glove demand will still remain strong as the usage of gloves will continue post-pandemic for hygienic reasons.

With demand seen sustaining into the future, not only are existing glove manufacturers ramping up production, we are also seeing an abundance of new players coming into the sector with the hope of capturing some market share and huge underlying returns.

We cannot blame these wannabe players as they are intrigued by the high earnings before interest, taxes, depreciation and amortisation (Ebitda) margin in excess of 70% currently. Even if margins are halved in the future, these new players see glove manufacturing as a goldmine.

Never mind if they are presently a tech company or a property player, being a glove manufacturer is being seen as a ticket to financial success.

With the industry's average selling price (ASP) now expected to trend lower, analysts have started to reduce their earnings projections and Table 1 basically summarises the brokers' call on the stock and the respective valuation method that was applied in arriving at a fair value for Top Glove. For most broking firms, the benchmark used to value Top Glove is based on the price earnings ratio (PER) multiple for 2022 calendar year (CY) earnings (Top Glove's financial year is August).

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Table 1: Top Glove's fair value

	Old TP (RM)	New TP (RM)	Change in Fair Value(%)	Valuation Matrix	Remarks
Maybank	8.65	4.85	-44%	DCF	DCF value starts from FY24
Affin Hwang	10.10	6.65	-34%	15x CY22	Previously valued at 22.7x CY22
Kenanga	8.50	6.80	-20%	13x CY22	FV will be reduced to RM5.80 post HK listing
RHB	8.45	6.80	-20%	DCF	Adjustment for lower ASP
AmInvest	5.63	5.46	-3%	23x CY22	Adjustment for ESG criteria (3%)
CGS-CIMB	7.80	7.80	0%	14x CY22	FV will be reduced to RM6.80 post HK listing
TA	7.80	7.80	0%	15x CY22	-
UOB Kay Hian	7.60	7.60	0%	18.5x CY22	FV will be redued to RM6.75 post HK listing
Public Invest	7.30	7.60	4%	8x CY21	-
Simple Average	**7.98**	**6.82**	**-15%**		

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Table 2: Top Glove's earnings estimates

RM'mil	FY-Aug-21		FY-Aug-22		FY-Aug-23	
	Revenue	Net Profit	Revenue	Net Profit	Revenue	Net Profit
Kenanga	24,780	10,893	14,676	4,802	-	-
TA	22,966	12,451	16,530	4,816	13,846	3,156
Affin Hwang	20,385	9,620	13,944	3,960	13,503	2,980
UOB	20,947	11,056	11,711	4,107	9,455	1,771
RHB	24,775	10,711	20,099	7,234	15,668	4,037
Maybank	24,430	11,228	20,598	6,383	17,191	3,122
CIMB	21,228	10,374	15,113	5,293	12,709	3,116
AmInvest	26,694	8,536	10,234	2,805	8,741	1,513
Public Investment	19,608	10,314	12,343	4,211	10,670	2,448
Bloomberg Consensus	**22,010**	**10,695**	**13,734**	**4,145**	**12,524**	**2,496**
EPS (sen)		**133.7**		**51.8**		**31.2**

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Even using the CY earnings, different broking firms are using different PER and this ranges from as low as 12 times to as high as 23 times. These analysts would normally justify as to which PER they are using based on historical PERs observed and this is than adjusted to reflect certain parameters they particularly feel to be relevant in their own assessment.

This could be in the form of a discount or premium to the historical PER or taking into consideration ESG issues or other factors. Of all the brokers' reports observed, one is using the current year CY earnings in deriving a fair value for Top Glove based on a PER multiple of just eight times, which is basically a low PER to reflect the peak earnings for Top Glove this year.

Other than the PER method, two brokers are using the discounted cash flow (DCF) method to value Top Glove. This is where it becomes tricky. For the DCF model to be able to reflect the future cash-flow projections, it is imperative to understand the nature of the business and its prospects going forward. The DCF method is appropriate for an asset that has a finite lifespan or the income stream is relatively predictable. This can be applied for the utility sector, toll highways or even build-operate-transfer assets like police quarters, student accommodation or healthcare facilities held by a special purpose vehicle respect to projections in relation to capital expenditure, terminal value growth rate and the period captured by the analyst to derive the present value of the future cashflows.

From Table 1, the first thing we observed is that there is a 15% drop in Top Glove's fair value to RM6.82 per share post-announcement, with four broking firms being the most aggressive in cutting target prices. Three others maintained their fair values and one actually raised it by about 4%. When an analyst adjusts numbers based on actual results, it is perfectly understandable as they actually make a fresh assessment based on the results itself, guidance given by the company and their very own estimates.

What is peculiar is when analysts starts to shift the goal post to justify their calls. Some start to use a lower PER multiple to justify the current lower share price while others roll-over their valuations to the next CY to sustain a buy call, but perhaps a lower PER as well.

Six or nine months ago, the converse was true when analysts were raising PER multiples when glovemakers' earnings were exploding and their share prices were skyrocketing, as analysts were then using the peak CY2021 earnings and not realising that this will likely fall through in later years.

The question is then, are analysts driven by fundamentals of the company or the share price of the company in valuing a company?

How fast the valuation matrix has changed in a short space of time! Not long ago, Top Glove was said to be potentially fairly valued at RM110 (before the two-to-one bonus issue) based on 52 times PER even!

Firm should call off HKEX listing

Table 1 also shows that Top Glove's fair value has not been adjusted for its planned primary dual-listing on the Hong Kong Stock Exchange (HKEX), which could see the company raising as much as RM7.77bil via the issuance of up to 1.495 billion new Top Glove shares. This massive issuance is of course without doubt dilutive as it represents some 18.7% of the company's current net share base of about eight billion shares, resulting in its enlarged share base of about 9.5 billion shares. As can be seen, the dilutive effect will result in a lower target price by about RM1.00 per share and will also lower earnings and dividends per share that Top Glove will pay in the future.

Based on Top Glove's Q2 results, the company is presently sitting on a net cash position (after perpetual sukuk) of about RM2.77bil. With the expected profit of another RM5bil in H2 of this financial year (FY21) and another RM4bil plus in FY22, Top Glove has sufficient cash that it is generating from the business for capital expenditure or any potential mergers and acquisition it intends to undertake. An equity fundraise is an expensive fund-raising exercise for existing shareholders as the cost of equity is much higher than the cost of debt.

Looking at Top Glove's current equity and debt structure, one can see that the cost of equity is approximately 8.5% based on a market risk of 10%, and the cost of debt is just at about 3% plus, net of tax. Hence, why deploy a more expensive instrument like equity when debt is a cheaper alternative, and at the same time, not to mention that Top Glove itself has ample room to raise debt given its net cash position?

In fact, with shareholders' funds of about RM6.84bil and assuming an ideal capital structure of about 30% in net debt, Top Glove can easily raise another RM5bil from the debt market and attain a more balance capital

Another point of contention for Top Glove is in relation to its dividend policy as well as share buyback programme. To-date, Top Glove has bought back some 200 million shares from the market costing about RM1.42bil. It has also raised its dividend payout with special dividends of 20% for the rest of this financial year on top of the usual 50% payout. The question is then, would it not make more sense for it to conserve the cash for business purposes and expansion, instead of dishing out dividends and carrying out share buybacks? With up to another 1.5 billion shares to be issued, the share buyback programme has turned out to be meaningless, as the huge share base will be an overhang on the market for Top Glove and at the same time reduce its return on equity too in the future. It is perhaps more appropriate for Top Glove to call off its HKEX listing rather than pursue it.

What is Top Glove's fair value?

Table 2 summarises Top Glove's current estimates by broking firms and Bloomberg consensus figures. As can be seen, Top Glove is expected to make some RM10.7bil in earnings this year, RM4.1bil in FY22 and RM2.5bil in FY23. In fact, Top Glove's net profit is expected to drop by about 61% next year and by another 40% in FY23, before resuming its normalised level. With an earnings per share (EPS) of 133.7 sen, Top Glove is expected to pay out about 93.6 sen per share for this financial year. With 16.5 sen paid previously, the remaining payout is another 77 sen for FY21. For FY22 and FY23, based on a normal dividend payout of 50%, shareholders are expected to receive some 26 sen in dividend for FY22. All in, Top Glove is expected to pay some RM1.03 in dividends for the rest of FY21 and FY22.

As FY23 is a normalised year in terms of financial performance, it is rather safe to deploy the five-year mean PER for Top Glove prior to the pandemic of about 20 times to the FY23 EPS of 31.2 sen to derive a fair value for Top Glove, before dividends. Adding the dividends to be paid out in FY21 and FY22, investors can then make out what is Top Glove's fair value.

Judging by how topsy turvy Top Glove's valuation has been based on different parameters and yardsticks used, it is important for an analyst to be driven by fundamental valuations and not get distracted by the vagaries of the market. While valuation is an art, there are ways analysts could be more grounded in terms of valuing a company and not get carried away either in a super-bull cycle or in a bear market. For Top Glove, the HKEX planned listing should be aborted and perhaps another better way to manage market expectations is to reveal a planned share buy-back programme in terms of value on an annual basis, just like how it has communicated its dividend policy.

These shares should also be cancelled for good and not re-distributed to shareholders in terms of dividend-in-spice as it then defeats the purpose of the share buybacks itself. (This is not a buy/sell report, readers are advised to engage their own investment advisors before making any investment decisions.)

Pankaj C Kumar is a long-time investment analyst. The views expressed here are his own.

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