ACQUISITION OF TWO FACTORIES POSITIVE FOR TOP GLOVE

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Top Glove Corp Bhd

(May 22, RM5.52)

Maintain outperform call with a target price (TP) of RM6.11: In an announcement to Bursa Malaysia, Top Glove Corp Bhd revealed that wholly-owned GMP Medicare Sdn Bhd had entered into two separate sale and purchase agreements to acquire the following two rubber glove assets: a factory (43,300 sq m in land size) erected on freehold land in Seremban with machinery, equipment and fixture and fittings (RM31.5 million) (versus the independent valuer's RM50.5 million), and another factory (7,700 sq m in land size) erected on leasehold land in Muar, Johor, together with machinery, equipment and fixture and fittings (RM7.5 million) (versus independent valuer's RM10.2 million).

The two factories have a combined production capacity of two billion pieces of latex gloves. This acquisition will only put a small dent on Top Glove’s net gearing of 13% as at Feb 28, 2017, as well as an operating cash flow averaging more than RM400 million per annum.

This latest corporate development by Top Glove is positive, a step in the right direction and a mild surprise to the market.

The newly announced acquisitions further amplify that Top Glove is committed towards fulfilling its goal to grow not only organically, but via acquisition.

More importantly, these acquisitions allow Top Glove to have bigger and direct access to China’s market (China sales account for 50% of total sales of the two factories).

With the latest acquisitions, the plants can immediately contribute to Top Glove’s bottom line, compared with a greenfield rubber glove plant which takes 12 to 18 months to commence operations.

We understand that currently, both factories generate a revenue of RM150 million per annum with a net margin of 2% to 3%.

However, with Top Glove’s management quality and track record of cost reduction and plant efficiency, coupled with the group’s bulk purchasing power, we expect that the net margin for the two factories can only improve.

We would not be surprised that plans are in place to upgrade the lines in order to enhance efficiencies, and hence improve margins considering that the average age of the lines is about seven years.

The two factories are expected to record a net profit of RM12 million per annum or 3% of our financial year 2018 (FY18) net profit forecast.

We leave our FY17 and FY18 forecasts unchanged for now.

We expect latex cost to trend downwards and volume sales to pick up again as buyers return to the market to replenish their stock.

Slower-than-expected new incoming capacities could lead to less-intense nitrile glove competition.

As an indication, the average selling price (ASP) of Top Gloves has been rising over the past two quarters, which suggests that price competition has abated.

Over the next two to three quarters, Top Glove's earnings will be underpinned by Factory 6 completed in December 2016 (Thailand; 1.4 billion pieces). Factory 30 (4.4 billion pieces) is being constructed and expected to commence production by this month.

Concrete plans are also in place for Factory 31 (Klang), for which Phase 1 will commence by November 2017 (previously August), with a production capacity of 2.8 billion gloves per annum.

Factory 32 with a capacity of 4.8 billion pieces per annum is expected to commence by December 2018, which will bring the group's total production lines to 632 and a production capacity of 60 billion gloves per annum (+20%).

We roll forward our valuation from FY17 to FY18. Correspondingly, our TP is raised from RM5.92 to RM6.11 based on an unchanged 20 times price-earnings ratio over our FY18 earnings per share forecast.

Key risks include higher-than-expected raw material cost and lower-than-expected ASPs. — *Kenanga Research, May 22*