

10 November 2020

Kossan Rubber (KRI MK)

The Best Quarter Is Yet To Come; **BUY**

Consumer Non-cyclical | Rubber Products

Buy (Maintained)

Target Price (Return): MYR9.00 (20.0%)
Price: MYR7.50
Market Cap: USD4,669m
Avg Daily Turnover (MYR/USD) 99.6m/23.9m

Analyst

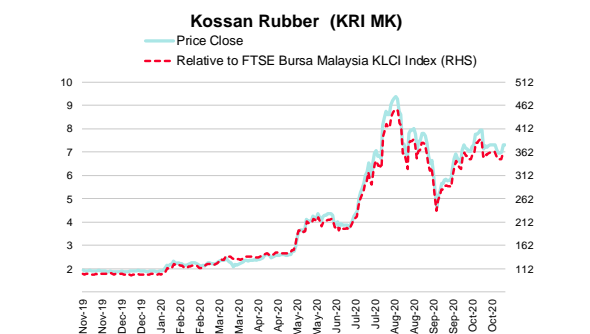
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- **Maintain BUY with higher DCF-derived MYR9.00 TP from MYR8.50, 20% upside and c.3% yield.** 3Q20 earnings beat expectations, on better-than-expected ASPs. There is also a chance for the stock to join the FBM KLCI next month, if Kossan maintains its current market cap until 23 Nov. Expansion plans are intact, with the completion of Plant 19 adding 10% to capacity. Our TP reflects 11x forward PE, which is at a 25% discount to peer average, reflecting its lower liquidity.
- **Earnings beat expectations.** Kossan's 9MFY20 core net profit of MYR545m beat expectations, as it makes up 105%/73% of our/consensus FY20 full year estimates. The outperformance is due to higher-than-expected ASPs. In line with better revenue, EBITDA margin improved to 32.8% in 9MFY20 (9MFY19: 17.5%).
- **Bonus issue completed.** On 13 Oct, Kossan completed its 1-for-1 bonus issue, with the listing of 1.28bn shares. Post bonus issue, the number of shares stand at 2.56bn.
- **A chance to join FBM KLCI in December.** The next review of FBM KLCI component stocks in December will be based on the market cap rankings at the close of business on 23 Nov – only about two weeks away. With a market cap of MYR19.2bn, Kossan is currently ranked 24th. As a security would be inserted into FBM KLCI, during the periodic review, if its ranking by full market value rises to 25 and above, we believe there is a chance that Kossan will join the FBM KLCI.
- **Expansion plans intact.** Kossan has completed Plant 19, with 3bn pieces pa (ppa) capacity in August. Effectively, its capacity has increased 10% to 32bn ppa. Looking ahead, Kossan plans to increase its capacity by 1.5bn ppa with the construction of Plant 20 – to be fully commissioned by 1HFY21.
- **BUY with higher TP.** We increase FY20-22F earnings by 91-160% to reflect higher ASPs, in line with the industry trend. The higher TP is in line with better earnings estimates. In the near term, we expect Kossan to register a stronger set of results in 4Q20, in line with the industry's higher ASP trend. In the long run, Kossan is a beneficiary of the long-term global uptrend in glove consumption,
- **Risks:** The biggest risk is a safe and effective COVID-19 vaccine being made available globally, faster than expected. Although Pfizer Inc and BioNTech SE announced that their mRNA-based vaccine candidate has demonstrated evidence of efficacy against COVID-19, note that this is the first interim efficacy analysis, and not the final one. Additionally, after the H1N1 pandemic of 2009-2010, glove demand only fell slightly YoY in 2011, by 1.3% or 2bn to 148bn ppa. Other risks are lower-than-expected sales volume/USD and higher-than-expected raw material prices.

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	260.6	3.7	(21.0)	156.4	257.1
Relative	264.7	4.1	(17.6)	146.1	262.4
52-wk Price low/high (MYR)				2.05 – 9.59	



Source: Bloomberg

Forecasts and Valuation	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Total turnover (MYRm)	2,141	2,276	4,571	7,576	7,364
Recurring net profit (MYRm)	200	230	1,178	2,091	1,836
Recurring net profit growth (%)	9.7	15.4	411.0	77.6	(12.2)
Recurring P/E (x)	96.03	83.24	16.29	9.17	10.45
P/B (x)	14.6	12.2	7.6	5.9	5.3
P/CF (x)	99.60	44.13	17.10	10.13	9.66
Dividend Yield (%)	0.4	0.5	2.5	4.4	3.8
EV/EBITDA (x)	57.35	46.92	10.12	5.70	6.43
Net debt to equity (%)	27.0	8.3	net cash	net cash	net cash

Source: Company data, RHB

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Financial Exhibits

Asia	Financial summary (MYR)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Malaysia	Recurring EPS	0.08	0.09	0.46	0.82	0.72
Consumer Non-cyclical	DPS	0.03	0.04	0.18	0.33	0.29
Kossan Rubber	BVPS	0.51	0.61	0.98	1.28	1.40
KRI MK						
Buy						
Valuation basis	Valuation metrics	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Discounted Cash Flow(DCF) FCFF valuation	Recurring P/E (x)	96.03	83.24	16.29	9.17	10.45
	P/B (x)	14.6	12.2	7.6	5.9	5.3
	FCF Yield (%)	(0.6)	1.0	4.5	8.6	8.3
	Dividend Yield (%)	0.4	0.5	2.5	4.4	3.8
	EV/EBITDA (x)	57.35	46.92	10.12	5.70	6.43
	EV/EBIT (x)	74.02	64.59	10.87	5.96	6.81
Key drivers	Income statement (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Earnings forecasts are most sensitive to changes in:	Total turnover	2,141	2,276	4,571	7,576	7,364
i. Sales volumes;	Gross profit	589	574	2,303	4,037	3,628
ii. USD/MYR;	EBITDA	341	412	1,847	3,183	2,820
iii. Nitrile butadiene prices;	Depreciation and amortisation	(77)	(113)	(128)	(143)	(158)
iv. Natural rubber prices.	Operating profit	264	299	1,719	3,040	2,662
	Net interest	(15)	(9)	1	14	20
Key risks	Pre-tax profit	249	291	1,720	3,054	2,682
Downside risks include:	Taxation	(45)	(55)	(516)	(916)	(804)
i. Lower-than-expected sales volumes;	Reported net profit	200	230	1,178	2,091	1,836
ii. Lower-than-expected USD/MYR;	Recurring net profit	200	230	1,178	2,091	1,836
iii. Higher-than-expected raw material prices.						
Company Profile	Cash flow (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Kossan is one of the world's Big 4 glove makers. It has a production capacity of 32bn pieces pa.	Change in working capital	(91)	77	(209)	(374)	(29)
	Cash flow from operations	193	435	1,122	1,893	1,987
	Capex	(315)	(250)	(250)	(250)	(400)
	Cash flow from investing activities	(314)	(245)	(236)	(223)	(368)
	Dividends paid	(38)	(92)	(471)	(837)	(735)
	Cash flow from financing activities	59	144	59	(865)	(805)
	Cash at beginning of period	210	146	367	1,048	1,631
	Net change in cash	(63)	333	945	805	814
	Ending balance cash	146	478	1,311	1,852	2,444
	Balance sheet (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
	Total cash and equivalents	146	367	1,048	1,631	1,606
	Tangible fixed assets	1,268	1,405	1,527	1,635	1,880
	Total investments	7	7	7	7	7
	Total assets	2,148	2,498	3,854	5,338	5,556
	Short-term debt	279	213	206	200	193
	Total long-term debt	229	287	280	272	264
	Total liabilities	806	891	1,270	1,949	1,853
	Total equity	1,342	1,608	2,584	3,389	3,703
	Total liabilities & equity	2,148	2,498	3,854	5,338	5,556
	Key metrics	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
	Revenue growth (%)	9.3	6.3	100.8	65.7	(2.8)
	Recurrent EPS growth (%)	(45.1)	15.4	411.0	77.6	(12.2)
	Gross margin (%)	27.5	25.2	50.4	53.3	49.3
	Operating EBITDA margin (%)	15.9	18.1	40.4	42.0	38.3
	Net profit margin (%)	9.3	10.1	25.8	27.6	24.9
	Dividend payout ratio (%)	40.0	40.0	40.0	40.0	40.0
	Capex/sales (%)	14.7	11.0	5.5	3.3	5.4
	Interest cover (x)	13.6	21.8	128.5	234.1	211.3

Source: Company data, RHB

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Figure 1: 3QFY20 results snapshot

FYE Dec (MYRm)	3QFY19	2QFY20	3QFY20	QoQ (%)	YoY (%)	9M19	9M20	YoY (%)	Comments
Revenue	531.3	701.7	1,033.3	47.3	94.5	1,643.3	2,346.5	42.8	9M20 volume up 21% YoY
EBITDA	87.6	189.8	467.3	146.2	433.7	287.9	768.7	167.0	Better ASP and higher volumes
<i>EBITDA Margin (%)</i>	<i>16.5</i>	<i>27.1</i>	<i>45.2</i>			<i>17.5</i>	<i>32.8</i>		
Depreciation	(22.0)	(25.6)	(28.4)	11.0	28.8	(67.4)	(79.3)	17.7	
EBIT	65.5	164.2	438.9	167.2	569.7	220.5	689.4	212.7	
<i>EBIT Margin (%)</i>	<i>12.3</i>	<i>23.4</i>	<i>42.5</i>			<i>13.4</i>	<i>29.4</i>		
Interest expense	(2.8)	(3.4)	(2.5)	(25.6)	(8.5)	(12.7)	(9.7)	(23.6)	
Pretax profit	62.8	160.8	436.4	171.3	595.2	207.8	679.8	227.1	
<i>Pretax Margin (%)</i>	<i>11.8</i>	<i>22.9</i>	<i>42.2</i>			<i>12.6</i>	<i>29.0</i>		
Tax	(12.6)	(28.5)	(85.2)	199.2	576.2	(41.5)	(131.0)	215.7	
<i>Effective tax rate (%)</i>	<i>20.1</i>	<i>17.7</i>	<i>19.5</i>			<i>20.0</i>	<i>19.3</i>		
Minority Interest	(1.0)	(1.3)	(2.4)	87.2	145.1	(2.6)	(4.2)	63.2	
Net Profit	49.2	131.1	348.7	166.1	609.2	163.8	544.6	232.5	105% of our forecast 73% of consensus
<i>Net Margin (%)</i>	<i>9.3</i>	<i>18.7</i>	<i>33.7</i>			<i>10.0</i>	<i>23.2</i>		
Core Net Profit	49.2	131.1	348.7	166.1	609.2	163.8	544.6	232.5	Beat expectations
<i>Core Net Margin (%)</i>	<i>9.3</i>	<i>18.7</i>	<i>33.7</i>			<i>10.0</i>	<i>23.2</i>		

Source: Company Data

Figure 2: Key assumptions

Key Assumptions	FY20F	FY21F	FY22F
Installed Year End Capacity (m ppa)	32,000	35,500	42,500
Blended ASP (USD per 1000 pieces)	33.5	48.3	45.6
Average USDMYR	4.025	4.025	4.025
Utilisation Rate	90%	90%	90%

Source: RHB

Our base case assumption for COVID-19 vaccine development. Our base case scenario is that a safe and effective vaccine will be available in 1H2021 under Emergency Use Authorization (EUA). Eventually, this should lead to lower glove demand in 2H21, assuming COVID-19 cases decline by then. As 85% of glove demand is from the medical segment, lower COVID-19 cases should reduce demand from this segment. According to Pfizer Inc. and BioNTech SE's press release, their "mRNA-based vaccine candidate, BNT162b2, has demonstrated evidence of efficacy against COVID-19 in participants without prior evidence of SARS-CoV-2 infection", based on the first interim efficacy analysis conducted on 8 Nov. This is for the Phase 3 clinical study. However, do take note that first interim result is not the final one.

We will be monitoring the progress of vaccine development closely, as one of the potential leading indicators for lower COVID-19 new cases in the future. Historically, after the H1N1 pandemic in 2009-2010, demand fell only slightly YoY in 2011 by 1.3% or 2bn, to 148bn ppa. The growth continued from 2012 onwards, and remains in positive growth until now. This has been reflected in our lower ASP for FY23F as compared to FY22F and FY21F.

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Figure 3: DCF valuation

FYE Dec (MYR m)	FY21F	FY22F	FY23F	FY24F	FY25F	FY26F	FY27F	FY28F	FY29F	FY30F	Terminal
CFO	2,672	2,504	2,159	2,259	2,642	2,700	2,759	2,819	2,903	2,990	
+ Interest (1 - Tax Rate)	10	10	9	9	9	8	8	8	8	8	
- capital expenditure	(250)	(400)	(350)	(350)	(350)	(350)	(350)	(350)	(350)	(350)	
Free cash flow to firm (FCFF)	2,431	2,114	1,818	1,918	2,300	2,359	2,417	2,477	2,562	2,649	26,145
Discount factor	0.99	0.88	0.78	0.69	0.61	0.55	0.48	0.43	0.38	0.34	0.34
PV of FCFF	2,407	1,858	1,418	1,328	1,414	1,287	1,171	1,065	978	897	8,858
Risk-free	4.0%										
Beta	1.29										
Cost of Equity	11.7%										
WACC	11.2%										
Terminal growth	1.0%										
Enterprise Value (MYR m)	22,682										
Cash	798										
- Debt	(451)										
Equity Value (MYR m)	23,029										
No of shares (m)	2,558										
Fair Value (MYR)	9.00										

Figure 4: Sensitivity of TP based on bull, base and bear case for blended ASP

Scenario	FY20F	FY21F	FY22F	Long Term	TP (MYR)
Bull	33.5	58.3	55.6	53.9	11.50
Base	33.5	48.3	45.6	43.9	9.00
Bear	33.5	38.3	35.6	33.9	6.50

Source: RHB

Upside risks to ASP are possible due to a raw material shortage. Owing to unprecedented demand for nitrile gloves (made from nitrile butadiene - NBR), the demand for NBR has spiked up. The situation has worsened, and caused NBR suppliers to raise prices by 20% every month since September. This is a strong indicator that almost all the NBR supply in the market has been booked, as buyers are now willing to pay higher prices. If this situation persist into 1Q21, it will lead to a longer-than-expected sustained increase in ASPs for nitrile gloves as demand continues to increase, while supply is limited by raw material shortage.

Recommendation Chart



Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2020-08-26	Buy	8.50	7.65
2020-07-14	Buy	7.75	6.75
2020-07-07	Buy	6.50	5.46
2020-05-15	Buy	5.05	3.84
2020-04-21	Buy	3.25	2.67
2020-01-23	Buy	2.85	2.32
2020-01-22	Neutral	2.35	2.34
2019-08-23	Buy	2.35	2.09
2019-05-15	Buy	2.14	1.88
2019-02-19	Buy	2.23	2.00
2018-08-20	Neutral	2.05	2.22

Source: RHB, Bloomberg

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