

**RESULTS – 3Q/FY10**

25 Nov 2010

For period Jul-Sep 2010

Kossan Rubber Industries		Price:	RM3.29
		Market Capitalisation:	RM1051.9m
		Board:	Main Board
Stock Code/Name:	7153 / KOSSAN	FBM Index:	EMAS Shariah/Small Cap
Recommendation:	BUY	Sector:	Industrial Products

Analyst: Edmund Tham

Key Stock Statistics	2011F
EPS (sen)	45.2
P/E (x)	7.3
Dividend/Share (sen)	16.0
NTA/Share (RM)	1.97
Book Value/Share (RM)	1.97
Issued Capital (mil shares)	319.7
52-weeks share price (RM)	2.425 – 4.275
Major Shareholders:	%
Kossan Holdings (M) SB	51.8
Kump. Wang Persaraan (KWAP)	6.9
Asian Small Co Portfolio	4.9

3Q/ 30 Sep	3Q10	3Q09	yoy %	2Q10	qoq%
Rev (RMm)	275.6	210.1	31.2	256.5	7.5
EBIT (RMm)	39.5	22.7	73.7	37.6	5.2
NPAT (RMm)	28.6	15.4	85.8	30.0	(4.8)
EPS (sen)	8.9	4.8	85.8	9.4	(4.8)

9M/ 30 Sep	9M10	9M09	yoy %
Rev (RMm)	794.9	609.2	30.5
EBIT (RMm)	117.8	62.2	89.5
NPAT (RMm)	88.9	42.8	107.7
EPS (sen)	27.8	13.4	107.7

Per Share Data	2008	2009	2010E	2011F
Book Value (RM)	0.93	1.12	1.64	1.97
Earnings (sen)	18.5	20.9	37.5	45.2
Dividend (sen)	6.8	12.0	14.0	16.0
Payout Ratio (%)	27.7	43.1	28.0	26.6
PER (x)	17.8	15.8	8.8	7.3
P/Book Value (x)	3.5	2.9	2.0	1.7
Dividend Yield (%)	2.1	3.6	4.3	4.9
ROE (%)	19.8	18.7	22.9	22.9
Net Gearing (cash) (x)	0.64	0.45	0.04	(0.06)

*2008 & 2009 figures adjusted for 1:1 bonus issue in July 2010

P&L Analysis (RM mil)	2008	2009	2010E	2011F
Year end: Dec 31				
Revenue	893.1	837.0	1081.6	1266.0
Operating Profit	84.1	96.5	160.8	193.0
Depreciation	(25.9)	(34.0)	(37.9)	(41.8)
Interest Expenses	(11.0)	(9.1)	(8.2)	(8.2)
Pre-tax Profit	73.1	87.4	152.5	184.8
Effective Tax Rate (%)	18.9	23.0	21.0	21.6
Net Profit	59.3	66.8	120.1	144.4
Operating Margin (%)	9.4	11.5	14.9	15.2
Pre-tax Margin (%)	8.2	10.4	14.1	14.6
Net Margin (%)	6.6	8.0	11.1	11.4

*50 sen par value

PERFORMANCE

Kossan's annualized 9M/FY10 revenue and net profit after tax and minority interest (NPATMI) were both **well within our earlier expectations**. Kossan's Q3 results attest to its continued resilience despite of the twin headwinds of high latex costs and weak US Dollar impacting the rubber glove manufacturing sector.

"Resilient Q3 performance"

During 3Q/FY10 ended 30th September 2010, Kossan recorded revenue that was 31.2% higher y-o-y versus 3Q/FY09. The group's NPATMI had also improved by 85.8% y-o-y. The higher revenue turnover and increase in earnings were attributed to the group's production expansion in the gloves division with a better product mix and also better margins.

Comparing q-o-q versus 2Q/FY10, Kossan's 3Q/FY10 revenue was 7.5% higher, while its NPATMI was slightly lower by 4.8%. The increase in sales turnover was due to the increase in the glove average selling price (ASP). The increase in selling price (year-to-date by about 30%) is in tandem with the increase in latex raw material prices.

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OUTLOOK/ CORP. UPDATE

“Global demand growth is always there”

The outlook for the global rubber glove industry remains positive for the near to medium term. We expect that the global demand for rubber gloves would continue to grow steadily by the usual 8-12% annually for the remainder of the year and next year, as well. For the year 2010, the global demand for gloves is expected to be approximately 150 billion pieces. Any disease outbreaks such as H1N1 would spur further global demand and consumption for gloves. Meanwhile, healthcare reforms in countries such as the US, Brazil and China would also boost the future demand and consumption for rubber gloves for the medical sector. Nevertheless, the sector is facing the twin headwinds of high latex prices and a weak US Dollar.

“Kossan unperturbed by headwinds”

Kossan's results in recent quarters have proven that the group's results are resilient and steadfast despite of the twin headwinds of strong latex prices and weak US Dollar. Kossan mitigated the risks with a product mix reflecting more resilient sales in its nitrile glove segment, its multinational companies (MNCs) customer base which is more stable and also its greater focus on producing and selling higher margin glove products. Kossan's performance, barring any future undesired foreign exchange losses, looks promising indeed. Kossan's management aims to grow its profitability faster rather than its production capacity.

In 3Q/FY10, Kossan sold 2.3 billion pieces of gloves (2Q/2010: 2.28 billion pieces), contributing to the total of 6.9 billion pieces in total for 9M/FY10. Adjusted for changes in product-mix to nitrile gloves, Kossan's effective installed capacity for FY09 stood at 9.2 billion pieces. The group's current overall production capacity utilization rate stood above 92%. Kossan's latest glove product mix is as follow – NR Powdered/NR Powdered Free/Nitrile in the ratio of 20:42:38. During 9M/FY10, about 90% of Kossan's revenue is derived from its glove division while the remainder 10% is derived from its TRP (technical rubber products) division. The group's PBT margin for its TRP division has improved significantly to 7.3% against 9M/FY09's 2.5%.

“Risk factors - the twin-headwinds of US Dollar and latex price volatility”

The appreciation of the Ringgit versus the US Dollar (USD) has affected the value of Kossan's USD-denominated sales receipts. Since last year, the Ringgit had steadily appreciated against the USD. The currencies of other rubber glove exporting nations such as Thailand and Indonesia have also appreciated against the USD. In recent months, the Ringgit had appreciated from above 3.30 to the USD and is now hovering around the 3.10 level against the USD. If the Ringgit continues to appreciate against the USD, there could be some risk of translation losses for Kossan, notwithstanding the success of any hedging efforts.

During 2010, rubber latex prices had surged strongly. Latex, the main raw material cost in the manufacturing of rubber gloves, constitutes around 50-60% of the company's costs. Fluctuation in latex costs can be inputted into the final selling price of rubber gloves. Nevertheless, it may face a 1-2-month time lag in price variation due to contractual and timing reasons. As such there are some risks on profit margins, especially from any strong and sudden surge in latex prices. Currently, wet-bulk-latex prices are around the RM8.70/ kg level.

Kossan has recognized and acknowledged the importance of a corporate culture that emphasizes good **corporate social responsibility (CSR)** and corporate citizenship. The company has contributed and worked for the betterment of employee welfare (via training, health & safety), market place (via customer satisfaction surveys) and community (via donations to various schools and organizations).

VALUATION

“Strong outlook and prospects remain”

With a steady global demand for gloves, we are objectively optimistic on Kossan's financial performance and future outlook. We favour Kossan for its strong Return On Equity (ROE), minimal gearing, high production capacity utilisation rate, strong technical/research capabilities and its focus on the higher-margin nitrile and powder-free natural rubber (NR) glove segment.

Results Coverage

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Nevertheless, the rubber glove sector continues to face risk factors such as a possible sectorial mismatch of production capacity versus demand, foreign exchange translation losses, surge in latex prices, time-lag in adjusting selling prices (to pass on any increase in latex costs) and any hikes in energy costs (oil, electricity and gas). For the production side, there could also be risks from delays in equipment delivery, commissioning hiccups, delays in approvals or obtaining new foreign labour and also a possible inadequacy in gas supply.

“Ample capacity for better dividend payout”

In April 2010, Kossan had declared a first and final tax exempt dividend per share (DPS) of 9 sen for its FY09 ended 31st December 2009. The net dividend amounting to RM14.4 million was paid in July 2010.

Kossan’s management did not provide us any dividend guidance, but we nevertheless expect Kossan to at least declare a DPS of 14 sen and 16 sen (a dividend payout ratio of close to 30%) for its FY10 and FY11 given the expected strong earnings. Based on the current market price, this would amount to a reasonable gross dividend yield of 4.3% and 4.9% for its FY10 and FY11, respectively.

“Still more upside expected”

Kossan’s adjusted beta (correlation factor) to the KLCI is 0.93, and its stock price (+21.2% YTD) has slightly outperformed the KLCI (+17.5% YTD) this year, despite of a sell-down of glove stocks in recent months. Do note that Kossan’s price had been halved subsequent to its 1-for-1 bonus issue in July 2010. Based on our new forecast of Kossan’s FY11 EPS and a relatively prudent estimated P/E (compared to the overall sector) of 10 times, we set a FY11-end **Target Price (TP) of RM4.52**, 37.3% above its current market price.

“Sell-down overdone”

We are very comfortable with Kossan’s business model and resilience, despite of the twin headwinds of high latex prices and weak US Dollar. We opine that the sell-down is way overdone, and there is further stock price upside during its FY11. As such, we **reiterate our Buy Call** on Kossan. Kossan’s FY11F valuation is still very attractive versus the domestic rubber glove sector’s P/E of 18.4 times and P/BV of 2.5 times.

Kossan: 6-month Share Price



Source: NextView

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