

**RESULTS – 2Q/FY10**

30 Aug 2010

For period Apr-Jun 2010

<b>Kossan Rubber Industries</b>		<b>Price:</b>	RM3.45
		<b>Market Capitalisation:</b>	RM1103.1m
		<b>Board:</b>	Main Board
<b>Stock Code/Name:</b>	7153 / KOSSAN	<b>FBM Index:</b>	EMAS Shariah/Small Cap
<b>Recommendation:</b>	BUY	<b>Sector:</b>	Industrial Products

Analyst: Edmund Tham

Key Stock Statistics	2010E
EPS (sen)	35.2
P/E (x)	9.7
Dividend/Share (sen)	14.5
NTA/Share (RM)	1.72
Book Value/Share (RM)	1.72
Issued Capital (mil shares)	319.7
52-weeks share price (RM)	1.90 – 4.28
Major Shareholders:	%
Kossan Holdings (M) SB	51.8
Kump. Wang Persaraan (KWAP)	7.4
Asian Small Co Portfolio	4.9

\*Figures adjusted for 1:1 bonus issue in July 2010

2Q/ 30 Jun	2Q10	2Q09	yoy %	1Q10	qoq%
Rev (RMm)	256.5	196.8	30.4	262.8	(2.4)
EBIT (RMm)	37.6	18.7	100.7	40.7	(7.7)
NPAT (RMm)	30.0	13.4	123.5	30.4	(1.2)
EPS (sen)	9.4	4.2	123.5	9.5	(1.2)

1H/ 30 Jun	1H10	1H09	yoy %
Rev (RMm)	519.3	399.1	30.1
EBIT (RMm)	78.3	39.4	98.6
NPAT (RMm)	60.4	27.5	119.9
EPS (sen)	18.9	8.6	119.9

**PERFORMANCE**

Kossan's annualized 1H/FY10 revenue was within our earlier estimates while its strong net profit after tax and minority interest (NPATMI) was about 20.5% above our earlier expectations.

**“Strong 1H performance”**

Looking at Kossan's 1H/FY10 revenue, it is up by 30.1% y-o-y to RM519.3 million. The higher sales turnover is mainly due to the higher volume of gloves sold. Meanwhile, Kossan's 1H/FY10 net profit after tax (NPAT) is up by an amazing 119.9% y-o-y to RM60.4 million. This increase in NPAT could be attributed to the company's better product mix and margins. As before, Kossan intends to increase its sales mix of nitrile gloves, which typically commands a better margin compared to natural rubber latex gloves.

**“Better product mix & higher ASPs”**

Comparing q-o-q versus the preceding 1Q/FY10, Kossan's 2Q/FY10 revenue came in 2.4% lower. This was mainly due to the Ringgit (RM) which strengthened by approximately 3% versus the US Dollar (USD) during the quarter. Nevertheless, Kossan's net margins were largely unaffected.

Per Share Data	2007	2008	2009	2010E
Book Value (RM)	0.79	0.93	1.12	1.72
Earnings (sen)	17.2	18.5	20.9	35.2
Dividend (sen)	9.4	6.8	12.0	14.5
Payout Ratio (%)	40.4	27.7	43.1	30.9
PER (x)	20.0	18.6	16.5	9.8
P/Book Value (x)	4.4	3.7	3.1	2.0
Dividend Yield (%)	2.7	2.0	3.5	4.2
ROE (%)	21.9	19.8	18.7	20.5
Net Gearing (x)	0.63	0.64	0.45	0.14

\*Figures adjusted for 1:1 bonus issue in July 2010

P&L Analysis (RM mil)	2007	2008	2009	2010E
<b>Year end: Dec 31</b>				
Revenue	702.6	893.1	837.0	1024.3
Operating Profit	68.6	84.1	96.5	147.2
Depreciation	(20.7)	(25.9)	(34.0)	(37.9)
Interest Expenses	(10.2)	(11.0)	(9.1)	(7.8)
Pre-tax Profit	58.3	73.1	87.4	139.4
Effective Tax Rate (%)	5.5	18.9	23.0	18.9
Net Profit	55.1	59.3	66.8	112.6
Operating Margin (%)	9.8	9.4	11.5	14.4
Pre-tax Margin (%)	8.3	8.2	10.4	13.6
Net Margin (%)	7.8	6.6	8.0	11.0

\*50 sen par value

All information, views and advice are given in good faith but without legal responsibility. Mercury Securities Sdn. Bhd. or companies or individuals connected with it may have used research material before publication and may have positions in or may be materially interested in any stocks in the markets mentioned.

This report has been prepared by Mercury Securities Sdn Bhd for purposes of CMDF-Bursa Research Scheme ("CBRS") administered by Bursa Malaysia Berhad and has been compensated to undertake the scheme. Mercury Securities Sdn Bhd has produced this report independent of any influence from CBRS or the subject company. For more information about CBRS and other research reports, please visit Bursa Malaysia's website at: [http://www.bursamalaysia.com/website/bm/listed\\_companies/cmdf\\_bursa\\_research\\_scheme/](http://www.bursamalaysia.com/website/bm/listed_companies/cmdf_bursa_research_scheme/)



## OUTLOOK/ CORP. UPDATE

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. A demand rebound for gloves is expected when customers from the US and Europe return after their summer holiday break in September 2010.

### “Steady demand growth for gloves”

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. As such, we were not particularly concerned by Kossan’s slight drop in revenue during its 2Q/FY10. Kossan mitigated this drop 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.

### “Focus on higher-margin product mix”

Kossan’s performance, barring any future undesired foreign exchange losses, looks promising indeed. Going forward, the group will focus more on the high margin products especially the nitrile segment. Kossan aims to grow its profitability faster rather than its capacity. Kossan’s management has also give reassurance that all the affected foreign exchange contracts had been fully exhausted and a stringent check and balance system is now in place to monitor the entire financial process of the group.

In 2Q/FY10, Kossan sold 2.32 billion pieces of gloves (1Q/2010: 2.38 billion pieces). During FY09, Kossan’s total quantity of glove sold stood at 8.45 billion pieces (FY08: 8.48 billion pieces). Adjusted for changes in product-mix to nitrile gloves, Kossan’s effective installed capacity for FY09 stood at 9.2 billion pieces. Kossan’s latest glove product mix is as follow – Powdered/Powdered Free/Nitrile in the ratio of 20:42:38. During 1H/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 current overall production capacity utilization rate stood above 90%. In order to meet the strong demand for gloves, the group is commissioning some 16 lines (Phase-1) that have been earmarked to produce nitrile gloves and these lines are expected to start contributing during 3Q/2010. The Phase-1 expansion will add some 1.6 to 1.8 billion pieces of gloves to the group’s existing total installed production capacity of 9.2 billion pieces. Another plant is scheduled to be ready in 2011, bringing Kossan’s number of plants to 12 and total production close to 14 billion pieces of gloves per year. Nevertheless, there could be risks from delays in equipment delivery, commissioning hiccups, delays in approvals for new foreign labour and also a possible inadequacy in gas supply.

### “Risks from FX and latex price volatility”

The appreciation of the Ringgit versus the USD has affected the value of Kossan’s USD-denominated sales receipts. Since last year, the Ringgit had steadily appreciated against the USD. In recent months, the Ringgit had appreciated from above 3.30 to the USD and is now hovering below the 3.15 level against the USD. If the Ringgit continues to appreciate against the USD, there could be some risk of translation losses for Kossan, not withstanding the success of its hedging efforts.

During the first quarter of 2010, rubber latex prices had surged strongly. Latex, the main raw material cost in the manufacturing of rubber gloves, constitutes some 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. In April 2010, the latex price had surged above RM7.60 per kg of Wet Bulk Latex. Currently, latex prices are still hovering around the RM7.00 per kg level.

### “Bonus issue completed”

In April 2010, Kossan had proposed a bonus issue and increase in its share capital. The proposed 1-for-1 bonus issue involves 159,866,976 new shares of RM0.50 par value each. Meanwhile, the proposed increase in authorised share capital involves an increase from RM150 million comprising 300 million shares of RM0.50 each to RM1 billion comprising 2 billion shares of RM 0.50 each. In July 2010, the bonus issue was duly completed.

---

#### Results Coverage

This report has been prepared by Mercury Securities Sdn Bhd for purposes of CMDF-Bursa Research Scheme (“CBRS”) administered by Bursa Malaysia Berhad and has been compensated to undertake the scheme. Mercury Securities Sdn Bhd has produced this report independent of any influence from CBRS or the subject company. For more information about CBRS and other research reports, please visit Bursa Malaysia’s website at: [http://www.bursamalaysia.com/website/bm/listed\\_companies/cmdf\\_bursa\\_research\\_scheme/](http://www.bursamalaysia.com/website/bm/listed_companies/cmdf_bursa_research_scheme/)

---

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”

With a steady global demand for gloves, we are surely optimistic on Kossan’s financial performance and future outlook. We have assumed better profit margins and minimal impact from foreign exchange losses during Kossan’s FY10. We favour Kossan for its strong Return On Equity (ROE), 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.

Nevertheless, the rubber glove sector continues to face risk factors such as a possible sectorial mismatch of production capacity versus demand, production labour shortages, 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).

### “Reasonable dividends”

In April 2010, Kossan had declared a first and final tax exempt dividend per share (DPS) of 9 sen for its FY09 ended 31<sup>st</sup> December 2009. The net dividend amounting to RM14.4 million was paid on 19<sup>th</sup> July 2010. We expect Kossan to declare a better DPS of 14.5 sen (a dividend payout ratio of 30.9%) for its FY10 given the expected strong earnings. Based on the current market price, this would amount to a reasonable gross dividend yield of 4.2% for its FY10.

### “More upside to follow”

While Kossan’s adjusted beta (correlation factor) to the KLCI is 0.96, its stock price (+27.1% YTD) has outperformed the KLCI this year (+11.8% YTD). Do note that Kossan’s price had been halved subsequent to its 1-for-1 bonus issue in July 2010. Based on our forecast of Kossan’s FY10 EPS and a prudent estimated P/E of 12 times, we set a FY10-end **Target Price (TP) of RM4.23**, 22.5% above its current market price. We would be setting a FY11-end TP for Kossan in due time.

### “Valuation still attractive”

As such, we are maintaining our **Buy Call** on Kossan. Kossan’s FY10E valuation is still very attractive versus the domestic rubber glove sector’s P/E of 17.0 times and P/BV 2.8 times.

### Kossan: 6-month Share Price



Source: NextView

All information, views and advice are given in good faith but without legal responsibility. Mercury Securities Sdn. Bhd. or companies or individuals connected with it may have used research material before publication and may have positions in or may be materially interested in any stocks in the markets mentioned.

This report has been prepared by Mercury Securities Sdn Bhd for purposes of CMDF-Bursa Research Scheme ("CBRS") administered by Bursa Malaysia Berhad and has been compensated to undertake the scheme. Mercury Securities Sdn Bhd has produced this report independent of any influence from CBRS or the subject company. For more information about CBRS and other research reports, please visit Bursa Malaysia's website at: [http://www.bursamalaysia.com/website/bm/listed\\_companies/cmdf\\_bursa\\_research\\_scheme/](http://www.bursamalaysia.com/website/bm/listed_companies/cmdf_bursa_research_scheme/)