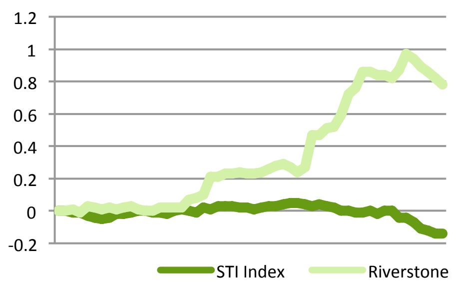
Riverstone Holdings Ltd

Target Price: 2.12 SGD (+27%)

20th September 2015

Last Closed Price:	1.66 SGD
12M Target:	2.12 SGD
Upside Potential:	27.1%
GICS Sector:	Industrials
GICS Sub-Industry:	Comm & Pro Services
Bloomberg Ticker	RSTON:SP

1Y Price v. Relative Index



Company Description

Riverstone Holdings Ltd is a Malaysian based company that specializes in selling cleanroom products that are mainly used by electronic manufacturers and healthcare industry.

Key Financials

Market Capitalization (mil)	601.39 SGD
Shares Outstanding (mil)	370.542
Free Float (%)	29.32%
52-Wk High	1.88 SGD
52-Wk Low	0.92 SGD
P/E (ttm)	26.04

(USD mil)	FY13A	FY14A	FY15E	FY16E
P/E (x)	11.76	13.49	17.86	15.18
P/B (x)	2.16	2.40	3.95	3.33
ROE (%)	20.09	19.70	24.24	23.32
Div Yield (%)	3.61	2.68	1.96	2.22
Net D/E	-	-	-	-
EBITDA (mil)	88.5	96.7	145.6	166.2
EBITMargin (%)	19.41	19.37	22.39	21.39

Key Executives

Chairman/ CEO	Wong Teek Son
Executive Director / COO	Lee Wai Keong
Group Business Dev Manager	Wong Teck Choon

Research Analysts:

Ong Zi Hao
Woo Kai Mun Dennis
Wu Yuchen
Xu Chen

Selling Gloves like Hot Cakes

Niche Nitrile Gloves Manufacturer

Despite being in a competitive industry with many players manufacturing gloves that are highly substitutable, Riverstone has carved a solid position in the market by targeting the high end segment of the market.

Product Concentration, Geographical Diversity

Riverstone has staked its claim in the industry by being critically focused on selling high quality, high margins nitrile gloves. The product has contributed over 90% in revenue while being safely diversified geographically. More than 75% of revenue segments hail from across Europe, South East Asia and China.

Strong Growth, Funded Internally

Despite being on an expansion phase, Riverstone generates sufficiently large profits to fund said expansion without taking on much debt from external sources. Its healthy financial debt-to-income ratio stands at 0.2.

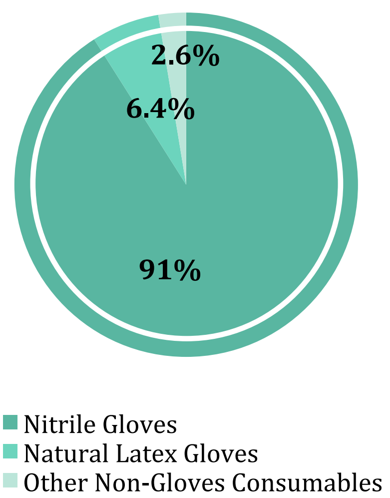
Key Investment Risks

Crude oil is a key raw material used to manufacture nitrile gloves. Given that the current high profit margins stems from the result of relatively lower oil prices, high profit margins can be eroded should oil prices rise as a result of supply shock. Additionally, the high margins coupled with low barriers to entry makes for lucrative entry for new entrants to compete for profits. Finally, rising cost as a result of new taxation policy from the Malaysian government may reduce profit margins as well.

Valuation

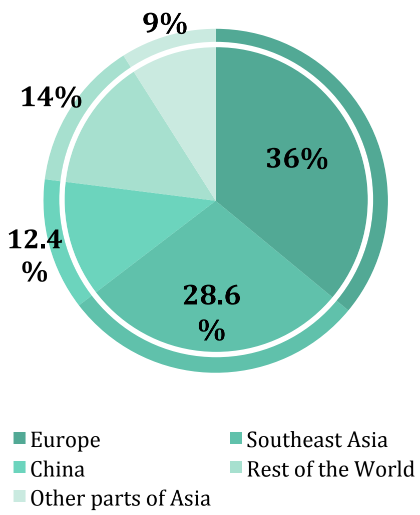
Using the discounted dividend valuation model, we have arrived at a base case intrinsic value of $2.12. Our upper and lower intrinsic value are $2.43 and $1.73 respectively. Our detailed methodology is described in the valuation segment.

Figure 1. Revenue by Division



Source: Company Data

Figure 2: Revenue by Geographical Segment



Source: Company Data

Company Overview

Riverstone Holdings Limited; one of the leading manufacturers in the cleanroom and medical industry, is involved in the production, sale and distribution of nitrile and natural rubber cleanroom gloves and premium nitrile gloves internationally. The customers of its proprietary RS Riverstone Resources branded gloves include leaders in the hard-disk drive, semiconductor, and healthcare industries. The company operates through two key business segments: Cleanroom and Healthcare Gloves, and Other Non-Gloves Consumables. First established in 1989 in Malaysia, Riverstone Holdings then became listed on the Mainboard of the Singapore Stock Exchange in 2006.

Revenue Breakdown

Riverstone Holdings' derives a large part of its revenue from its core business of the sales of Cleanroom and Healthcare Gloves. As seen in Figure 1, sales contribution of gloves accounted for 97.4% of its revenue, while contribution from other non-glove products made up the remaining 2.6% of its revenue. Figure 2 shows the geographical breakdown of the company's revenue. The top 3 geographical markets contributing to the revenue were Europe, Southeast Asia and Greater China, accounting for 36%, 28.6% and 12.4% of its revenue respectively.

Gloves Manufacturing Business

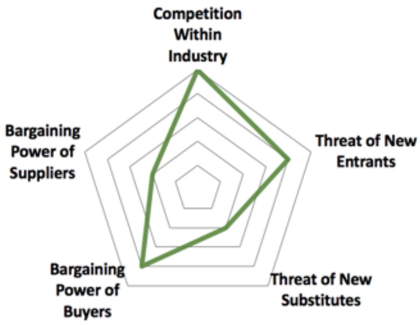
The Gloves Manufacturing business segment is the fundamental business of Riverstone Holdings, which can be further divided into two sub-segments; cleanroom gloves, and healthcare gloves. Under the first segment, nitrile and natural rubber gloves are manufactured primarily for use in a Class 10 and Class 100 cleanroom environment. As for healthcare gloves; 2009 saw the production and sales of these gloves to distributors in Europe and the U.S. Of both cleanroom and healthcare gloves, Riverstone Holdings produces them in a 40:60 ratio by volume. However, the proportion of revenue contribution is 60:40; thus reflecting the higher value of the cleanroom gloves. The company is estimated to have healthy gross margins of 38-40% for the cleanroom gloves. Finally, it is expecting an 8-12% annual growth for the healthcare gloves sector, given rising global awareness on healthcare standards.

Non-Gloves Consumables Business

The Non-Gloves Consumables business segment currently offers cleanroom consumable products such as finger cots, face masks, face pouches, jumpsuits, wipers and packaging materials. These products are designed to reduce contamination to the cleanroom environment caused by particles and other impurities. The company undertakes the full production of these products from the sourcing of raw materials to the preparation and delivery of these products. Riverstone Holdings also intends to expand the range of packaging materials to include moisture barrier bags, static shielding bags and electrostatic discharge (ESD) bags to better support their customers in various relevant industries.

Industry Analysis & Competitive Positioning

Figure 3: Porter's Five Forces



Source: Team Consensus

Competition Overview, Porter's Five Forces Analysis

Overall, our team rated the industry at 3.5 on a scale of 1 – 5, with 1 being no competition hence a monopoly and 5 being perfect competition. The key factors that will threaten Riverstone's high growth are the intense competition within the industry, high probability threat of new entrants and the high bargaining power of buyers.

The threat of new entrants is high because the glove manufacturing industry has low barriers to entry. Manufacturing process is relatively simple compared to other industry like pharmaceuticals and high tech. This means that a huge profit margin will attract new entrants into the market, thereby eroding profits away from Riverstone.

Bargaining power of buyers is high as consumers in the industry are big businesses that buy in bulk. This means that they have monopsony power to bargain for lower prices. With a relatively competitive industry, there is very little guarantee that current players will still be in the market. This is a huge threat to Riverstone and we will address this in our recommendations.

Diversified & Growing Demand

Traditionally, Riverstone focused on supplying gloves to cleanroom manufacturers. The recent venture into producing nitrile gloves for the healthcare sector in 2009 has proven to be timely and contributed to the strong group revenue performance. The demand for Riverstone healthcare gloves was also less affected by the normalization of demand for healthcare gloves in 2010 as Riverstone focused on the niche, high-end, customized nitrile gloves. Revenue from healthcare gloves grew 78% in 2010, and 300% in 2011, followed by a slower growth of 23% in 2012 and 30% in 2013. Considering that Riverstone only ventured into the healthcare gloves sector in 2009 and with its expanded customer base, it will not only continue to dominate the electronic sector, but also advance to become a key player in high-end healthcare sector.

Advantages of Nitrile Gloves

Unlike other competitors mainly focusing on natural latex gloves, Riverstone specialises in producing nitrile gloves, a form of synthetic tri-polymer that displays similar characteristics to natural rubber. Yet unlike rubber, it is faster and cheaper in production. From an end user perspective, nitrile gloves contain no natural protein and thus eliminate the well-documented protein risks associated with natural rubber products. It has accounted for 91% of the group's revenue in FY 2014; a big improvement from the 85.7% from 2011.

Figure 4. Historical Growth Rates (Past 7 years CAGR)

Revenue	18.4%
Net Income	18.6%
Cashflow from Operations	16.9%

Source: Company's Annual Report

Figure 5. Profitability Ratios

ROE	19.7%
ROA	17%
Net Profit Margins	19%
Asset Turnover	91%
Free Cashflow to Revenue ratio	-3%

Source: Company's Annual Report

Figure 6. Financial Health Ratios

Financial Leverage	1.15x
Debt to Income ratio	0.2
Current ratio	3.7
Interest Coverage	113x

Source: Company's Annual Report

Figure 7. Peer Comparison

Industry Peers	ROA	P/E
Riverstone	17%	22
LMA Intl' NV	11%	14
Medi-Flex Ltd	19%	14
Techcomp Ltd	5%	14

Source: Phillip Capital Stock Analytics

Investment Thesis

Economic Moat

Theoretically, in this industry, consumers (businesses) tend not to have brand loyalty as nitrile gloves are seen as a commodity product that is highly substitutable. However, that being said, Riverstone Holdings' past performance suggests otherwise. Having more than 10% CAGR in revenue, net income, and even cashflow from operations for over the past 7 years, it is indicative of a company with some form of economic moat.

Based on its annual report, the company has positioned itself to target the high quality, high margin segment of nitrile gloves which constitutes over 90% of its revenues. Such premium branding helps maintain its niche position in the competitive market.

Future Growth

As mentioned in the annual report, demand for nitrile gloves are driven by cleanroom electronic manufacturers and healthcare R&D. These two industries are likely to expand in the future, meaning that there will be continued and increasing demand for Riverstone Holdings' products. Based on estimates, the industry for nitrile gloves is likely to grow by 5-10% per annum. The financial health of Riverstone Holdings seems rather strong as the growth rates, earnings and even debt ratios are at very healthy levels. The ROA of 17% is very promising, and debt levels are extremely low as the company fund most of its expansion plans organically. The only red flag that we wish to point out is the company's negative cashflow to revenue ratio. However, as this company is relatively small and it is still at its growth phase, it is expected to be reinvesting excess cash to fuel its expansion programmes.

Bear Case

In the long run, given the low barriers to entry and high profit margins, it is probable that the current healthy profits will be competed away with new entrants in the industry. Also, given that the global economic outlook at time of writing is not so optimistic; some companies may consider certain measures to cut costs. For instance, some of Riverstone Holdings' customers may choose to switch to a cheaper nitrile glove manufacturer from China in order to reduce operating costs. Overall, with a competitive industry and a high degree of substitution from cheaper sources, it is uncertain if Riverstone Holdings will be able to maintain its strong economic moat in the long run.

Recommendations

There is room for growth and expansion given that Riverstone is still a relatively small company and the industry is set to grow at a rate of 5-10% per annum. The high ROA of 17% (contributed by high profit margins and high asset turnover) is very attractive for investors. In terms of financial health, despite being in an expansion phase, the company has almost zero debt since they fund expansions internally. With a valuation of $2.23 and the current price of $1.66, this is a textbook example of a good company that is undervalued. However, in the long term, the low barriers to entry in the industry might entice new entrants to enter and compete away profits. Therefore, it is still uncertain if Riverstone Holdings can maintain its brand position as a premium nitrile glove manufacturer in the long run.

In sum, Riverstone Holdings is very impressive financially and undervalued by approximately 30%. We are optimistic that there is still room for growth in the medium term (3-5 years). One caveat: investors should monitor the industry closely for the threats of new entrants.

Overall, our recommendation is a **BUY**.

Valuation

For the valuation of Riverstone Holdings, we did not split the business into several revenue sectors but instead evaluated the business as a whole because more than 97.4% of its revenue is generated from production of gloves. Due to the availability of its dividend data and stable amount of dividend paid out, we used the discounted dividend model to evaluate the value of the company; of course, based on a few assumptions.

Figure 8: Base Case Assumptions

WACC	5.68
Dividend Growth	3%
Future Operation Expense Ratio	13%
Future Revenue Annual Growth	8%
Increase Utilisation Rate	5%
Gross Margin	28%
Payout Ratio	40%

Source: Assumption based on market data and company reports

Figure 9: Optimistic Case Assumptions

WACC	5.68
Dividend Growth	3%
Future Operation Expense Ratio	13%
Future Revenue Annual Growth	10%*
Increase Utilisation Rate	5%
Gross Margin	32%*
Payout Ratio	40%

Source: Assumption based on market data and company reports.
**: Modified assumptions.*

Figure 10:Pessimistic Case Assumptions

WACC	5.68
Dividend Growth	3%
Future Operation Expense Ratio	13%
Future Revenue Annual Growth	6%*
Increase Utilisation Rate	5%
Gross Margin	25%*
Payout Ratio	40%

Source: Assumption based on market data and company reports.
**: Modified assumptions.*

Base Case

Largely due to the increase in production capacity from completed construction at the end of 2014, and higher utilisation rate from the adoption of a more advanced system, Riverstone Holdings' sales revenue increased by 38.7% in H1Y2015. Comparing to H1Y2014, this was more than a 68.7% jump in net profit. Assuming the growth rate will last through the second half of the year, we are predicting an annual growth rate of 35% for the company in Y2015. With higher utilisation rate, we expect the gross profit margin to increase as well. However, the gross profit margin is also subject to the cost of production. While unable to transfer the cost increase to customers entirely, the company may face a lower gross profit margin due to more expensive crude oil price. So we are projecting a conservative gross profit margin of 28%.

We used the average historical operation expenditure over revenue ratio to forecast the future operating expenses. For the following years, we expect the revenue growth to slow down as the market gets saturated, and eventually settle at 8% (the average rate for the industry). For years after 2019, we also assume the dividends to be increased at 3% (the average increase in the past 5 years) per share. Discounting the dividends with a discount ratio of 5.68% and a 3% dividend growth, we arrive at a current value of **2.12 SGD** per share.

Figure 11: Forecast Statistics from 2015 – 2019.

Year	2014	2015**	2016	2017	2018	2019
Revenue*	399,327	539,091	663,082	742,652	816,918	882,271
Gross profit*	108,863	172,509	198,925	222,796	228,737	247,036
Operating Expenses*	37,910	43,099	48,999	55,707	63,332	72,002
Net Profit*	70,953	129,410	149,925	167,089	165,404	175,034
Earnings/Shares	19.1	34.8	40.4	45.0	44.5	47.1
Dividend/ Shares	6.9	13.9	16.1	18.0	17.8	18.8
Dividend/Shares (SGD)	0.023	0.046	0.054	0.060	0.059	0.063

**: Number in RM'000.*
***: Annual data forecasted based on Q1Y2015 and Q2Y2015.*

Optimistic & Pessimistic Case

To take unexpected risk and reward into account, we performed both optimistic and pessimistic forecasts based on different assumptions. In the optimistic forecast, we predict the revenue will be at 10% as the company will continue growing with greater sales volume. In addition, we believe Riverstone can maintain a relatively higher gross profit margin in the next few years as well. This translates into a higher target price of **2.43 SGD**. On the other hand, in the pessimistic scenario, we expect that Riverstone may encounter a lower revenue growth of 6% due to increased competition and stagnated market growth. Also, we assume that the increase in utilisation rate may not result in higher gross margin due to increasing cost of raw materials. With these assumptions, we arrive at a lower target price of **1.73 SGD**.

Key Investment Risks

Uncertainty in Commodity Price Fluctuation

Riverstone Holdings' revenue is extremely concentrated in the nitrile gloves production as elaborated in the previous parts. It has enjoyed a high gross profit margin partially due to the relatively low commodity prices, especially that of crude oil. Since nitrile is a petroleum-based product and is affected by the increase in the prices of crude oil, any increase in oil price in the future will increase the cost of production for nitrile gloves. If OPEC starts to cut their oil production, driving the oil price up, Riverstone Holdings' financial position will be negatively compromised.

Increasing Competition in the Nitrile Gloves Market

The cleanroom gloves market has gradually shifted its preference of traditional latex gloves to nitrile gloves in the past few years. Riverstone benefitted tremendously from this shifting of demand with its first-mover advantage in the nitrile gloves market. However, while there are just a few new entrants to this market at present, we can expect many others in the future. Nitrile glove production is exceptionally competitive as all the manufacturers can only offer the same few similar products. The homogeneity of the products and low barriers to entry will both impose greater competition for Riverstone Holdings in the future.

Higher Cost of Running Business in Malaysia

After picking up in 2014, the Malaysian economy looks set to slow down again in 2015, with its growth rate constricting to 4.8% (forecasted). Also, in order to narrow its budget deficit, the government has begun a fiscal consolidation process aimed at balancing the budget by 2020. Some of the policies include the introduction of VAT at 6%, the extension of property tax and the reduction of subsidies for electricity and petrol. The tightening of fiscal policies will inevitably increase the operating expenses for Riverstone Holdings which has its manufacturing base in Malaysia, as well as bring about a lower profitability level due to higher tax.

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