# Undervalued Ansell Provides Investors Adequate Margin of Safety

As temporary pressures abate, we see drivers emerging for structural margin expansion.

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**Contents**




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## Executive Summary


Ansell shares appear undervalued as we anticipate current EBIT margin pressures to largely abate. The market still appears cautious on new industry capacity potentially competing with Ansell's more differentiated products and Ansell's ability to pass through inflationary cost pressures. We remain positive on both fronts. We see limited competitive pressure on Ansell's differentiated products and reiterate its narrow moat rating based on intangible assets. We also still see a long runway of growth in Ansell's emerging markets, where glove use per capita still significantly trails more mature markets, and in workplace safety and hygiene.

We expect long lead times due to supply chain constraints to normalise, and pricing for undifferentiated single-use exam gloves to stabilise lower around precoronavirus levels by fiscal 2024. We expect elevated input and shipping costs to ease in the medium term, which should allow margins to expand cyclically. We also see clear tailwinds for structural margin expansion with Ansell shifting more of its manufacturing in-house, gaining efficiencies from better utilisation of its newer manufacturing facilities, and an improved sales mix from higher-margin, differentiated products. We think the margin expansion story is not reflected in Ansell's relatively undemanding one-year forward P/E of 14.5 times.


## Key Takeaways

- Ansell is one of the most attractive stocks in our healthcare coverage, currently trading at a price/fair value estimate of 0.88 versus the sector average of 1.06.
- We forecast underlying group EBIT margin recovering to 15.0% by fiscal 2027 from 12.6% in fiscal 2022 as temporary margin pressures abate and drivers for structural margin expansion emerge.
- Despite a softening top line in the near term, as pandemic-induced demand subsides, the margin expansion story at play still drives our forecast five-year EPS CAGR of 5.8%.

## Companies Mentioned

| Name/Ticker | Economic Moat | Currency | Fair Value Estimate | Current Price | Price /FVE | Uncertainty Rating | Morningstar Rating | Market Cap (Bil) |
|---|---|---|---|---|---|---|---|---|
| Ansell/ANN | Narrow | AUD | 32.00 | 28.32 | 0.88 | Low | ★★★★ | 3.60 |

## Larger Margin Expansion Story at Play Underpins Our Investment Thesis

Shares in narrow-moat Ansell trade at a compelling discount of roughly 10% to our AUD 32.00 fair value estimate. We forecast group EBIT rising to USD 322 million by fiscal 2027, from USD 245 million in fiscal 2022, equating to a forecast five-year CAGR of 5.6%. This is largely driven by our expectation that underlying group EBIT margin recovers to 15.0% by fiscal 2027 from 12.6% in fiscal 2022. This is 80 basis points higher than Ansell's preceding three-year historical average of 14.2%, as Ansell shifts more of its manufacturing in-house, gains efficiencies from better utilisation of its newer manufacturing facilities, and benefits from an improved sales mix.

**Exhibit 1** We Assume a Larger Margin Expansion Story Is at Play (USD)

| Morningstar vs. Consensus | Earnings Metric | F23e | F24e | F25e |
|---|---|---|---|---|
| Morningstar | Revenue | 1,866m | 1,933m | 2,002m |
| | EBIT | 234m | 261m | 287m |
| | EPS | 128c | 145c | 161c |
| Consensus | Revenue | 1,857m | 1,925m | 1,990m |
| | EBIT | 226m | 244m | 257m |
| | EPS | 124c | 135c | 144c |
| Difference | Revenue | 0% | 0% | 1% |
| | EBIT | 3% | 7% | 12% |
| | EPS | 3% | 7% | 12% |

Source: Morningstar estimates, PitchBook. Data as of Oct. 31, 2022.

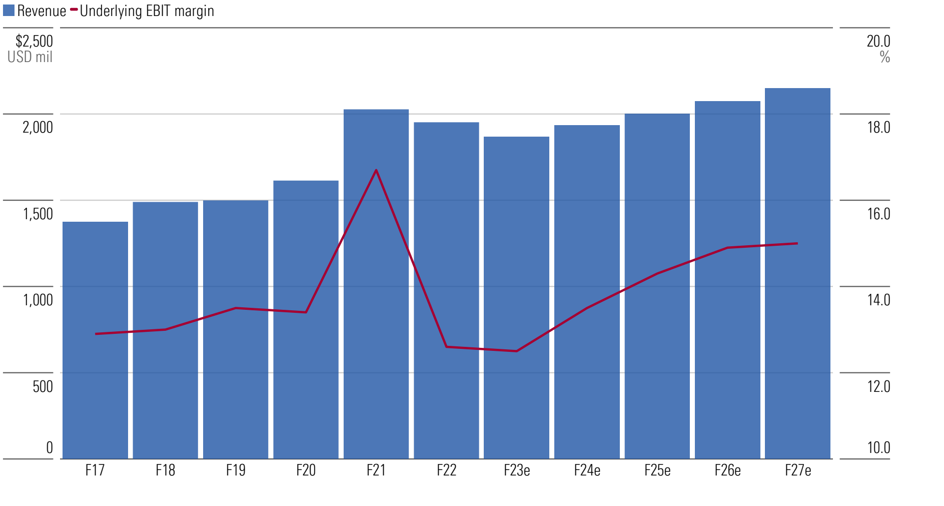
While our forecast three-year group revenue CAGR of 0.9% is broadly in line with market consensus, we are significantly more optimistic on Ansell's ability to expand margins compared with market consensus. Ansell's margin expansion story underpins our investment thesis. We also anticipate Ansell's share price is likely to rerate to roughly 16.5 times one-year forward EPS (as implied by our AUD 32.00 fair value estimate) versus roughly 14.6 times currently as this margin expansion comes through and investor concerns subside.

## Market Selloff on Ansell's Sharp Margin Contraction Provides Investment Opportunity

Ansell's share price declined roughly 50% in fiscal 2022 versus an approximate 10% fall in the S&P/ASX 200 Index. Despite cycling unprecedented demand for single-use exam gloves in fiscal 2022 and then facing price normalisation as industry supply caught up with demand, fiscal 2022 organic revenue fell just 2% in constant currency to USD 1.95 billion given solid performance across Ansell's mechanical, surgical, and life science segments driven by market share gains and strong demand conditions.

We think the main reason for the market's more cautious outlook is less to do with the top line, but rather the sharp margin contraction in fiscal 2022. We believe the market has over-reacted to largely temporary margin pressures and now provides investors with an opportunity to purchase the stock at a discount.

**Exhibit 2** Current Margins Are Cyclically Weak, but We Expect Structural Margin Expansion



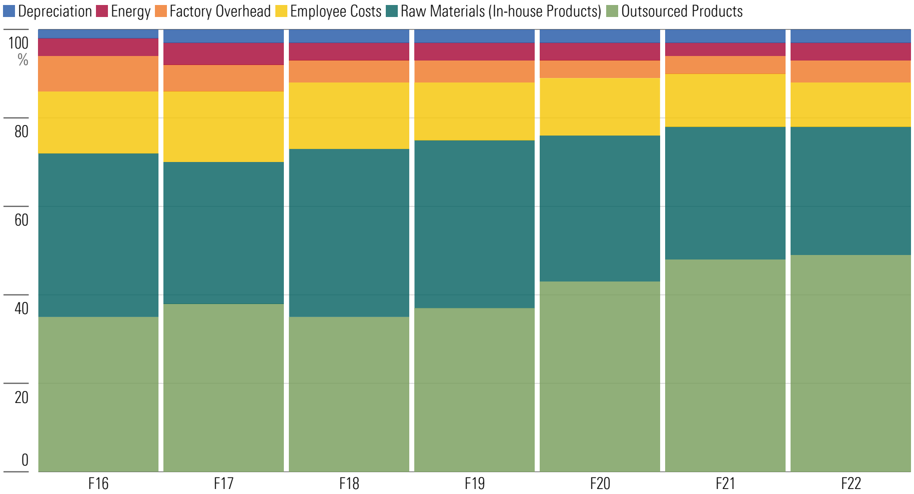

Source: Morningstar estimates, Company filings.

**Overpriced Inventory Weighs on Margins, but Not for Long**

Ansell's first-half fiscal 2022 gross margin sharply compressed to 32% from 40% in the prior corresponding period reflecting high-priced inventory as a result of elevated commodity and freight costs. Ansell outsources the manufacturing of its more undifferentiated commoditised gloves, including standard thin single-use exam gloves that were sought after during the pandemic. The cost of these gloves is much more affected by commodity inputs, and in the pandemic demand was elevated. As market prices for inputs and gloves normalise, the sale of high-priced inventory is weighing on margins.

Ansell estimates high-cost inventory, and the associated supply chain issues, reduced first-half fiscal 2022 gross profit by USD 20 million and lowered group gross margins by 2.0 percentage points. An inventory write-down and temporary closures of Ansell's manufacturing sites due to coronavirus transmission also hit first-half fiscal 2022 gross profit by a further USD 17 million, reducing group gross margins by a further 1.7 percentage points. High-cost inventory and elevated demand meant Ansell's outsourced products as a percentage of cost of goods sold grew to 49% in fiscal 2022 versus the typical 36% prepandemic.

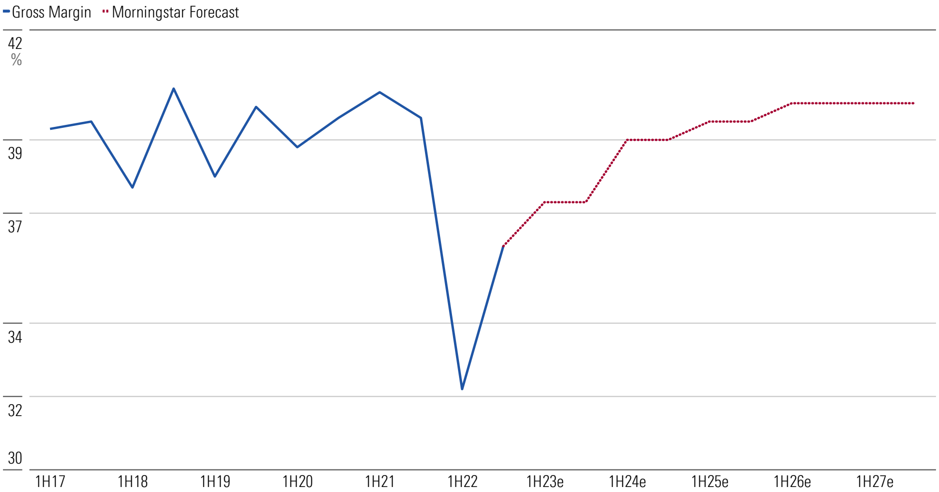
**Exhibit 3** We Expect Outsourced Products as a Percentage of COGS To Normalise Back to Prepandemic Levels




Source: Company filings.

However, the impact of higher-cost inventory is waning and we expect margin pressures to continue to ease. Second-half fiscal 2022 group gross margin recovered to 36% from 32% in the first half. Excluding Ansell's Careplus joint venture, Ansell's Healthcare EBIT margin in second-half fiscal 2022 expanded to 17% from 11% in the first half.

**Exhibit 4** Ansell's Margin Recovery Has Already Begun




Source: Morningstar estimates, Company filings.

**Clear Catalysts for Ansell's Continued Margin Recovery**

We forecast Ansell's group gross margin to recover back to 39% by fiscal 2024, from 34% in fiscal 2022, and reach 40% at midcycle, or fiscal 2027. When commodity prices and inflation have been more normal, as we again expect in future, Ansell's gross margins have tended to be stable around 39% since fiscal 2017. Improving gross margins drive our forecast underlying group EBIT margin expansion to 15% by midcycle from 13% in fiscal 2022.

Beyond inventory, we also see gross margin expansion from a mix shift toward higher-value products and likely further input cost falls. We expect COGS for lower-value outsourced products as a percentage of total COGS to revert to the typical prepandemic average of 36% by fiscal 2024 and trend lower. We see pandemic-induced demand normalising for Ansell's outsourced products; Ansell is continuing its strategy to shift more of its manufacturing in-house, and increasing utilisation and efficiencies gained from newer facilities and automation. We also see margin upside from rubber prices trending down from recent highs. Further, we expect Ansell to benefit slightly from an improved sales mix from higher-margin differentiated products as pandemic demand for undifferentiated single-use exam gloves subside.

Ansell continues to bolster its insourced manufacturing capacity by investing in production capacity projects at existing and new facilities, as well as manufacturing capabilities such as automation. Ansell's fairly new Thailand facility began operating its fifth production line of differentiated single-use gloves in March 2022, with two more lines set to start in fiscal 2023. In addition, Ansell is investing USD 80 million over three years for a new greenfield project in India to boost its manufacturing capacity of surgical and life science gloves with production set to start in fiscal 2024. In the event of industry overcapacity, we think Ansell's diversified portfolio of products and mix of insourced and outsourced manufacturing still ensures some flexibility to shift resources and meet changing volumes. Ansell's in-house manufacturing is well diversified across 14 manufacturing facilities globally and continues to expand steadily.

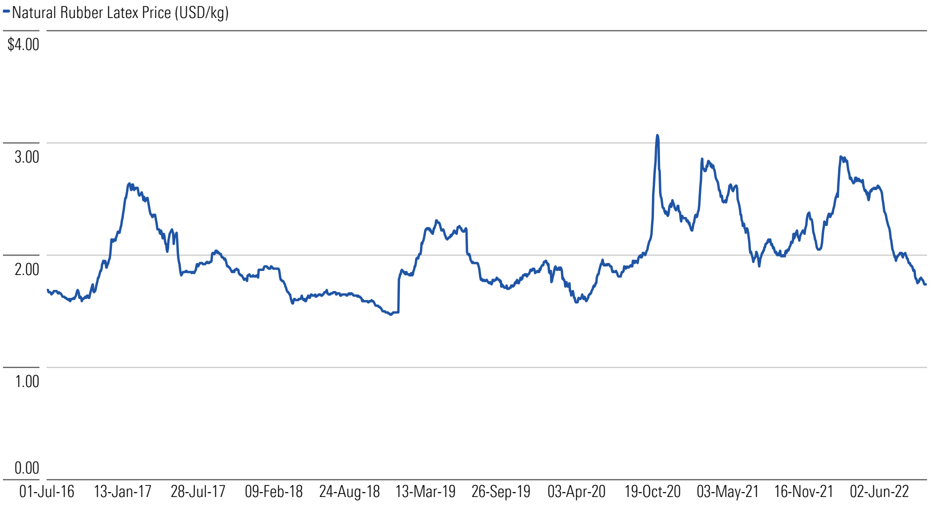
We also see likely further commodity price relief. The price of nitrile butadiene rubber which is a byproduct of petroleum and used to make synthetic latex, has been trending down since November 2021. The current NBR spot price is roughly 27% lower than the peak in the December 2021 quarter and yet to stabilise. Nitrile latex made up roughly 15% of Ansell's first-half fiscal 2022 total operating expenses, but we expect this to trend down given recent price movements. In addition to commodity price relief, we also expect the company to utilise more neoprene in its product formulations to limit its exposure to future rubber price movements.

**Exhibit 5** Cost of Nitrile Butadiene Rubber Continues To Trend Lower


Source: China National Bureau of Statistics, Haver Analytics.

Similarly, natural rubber latex, which made up roughly 5% of Ansell's first-half fiscal 2022 COGS, or 4% of total operating expenses, has also reverted back to prepandemic levels.

**Exhibit 6** Cost of Natural Rubber Latex Has Reverted Back to Prepandemic Levels




Source: Malaysian Rubber Board, Malaysian Rubber Exchange, Haver Analytics.

The company passed through product price increases in January 2022, in response to cost inflationary pressures in raw materials as well as elevated freight costs. In August 2022, management stated the firm is still offsetting all cost inflationary pressures via price increases, the full benefits of which we expect to flow through by fiscal 2024. With cost pressures easing since August 2022, we anticipate Ansell's margins to benefit in the near term from recent product price increases as well as lower input costs. In addition, we anticipate elevated freight costs to continue moderating in second-half fiscal 2023.

Last, we see upside from an improved sales mix due to higher-margin differentiated products. However, we expect the margin upside from this to be fairly small given the majority of Ansell's earnings already stem from differentiated products. Despite pandemic-induced demand, undifferentiated single-use exam gloves made up just 30% of Ansell’s single-use sales in fiscal 2021, or roughly 10% of group sales, and trending down. Ansell's revenue split is well diversified and explains the resilient top line in fiscal 2022.

**Exhibit 7** Ansell's Portfolio of Products Is Well Diversified Across Various Verticals

| F22 Revenue Split | % |
|---|---|
| Exam/Single Use | 37.17 |
| Surgical | 18.28 |
| Life Sciences | 5.88 |
| Mechanical | 24.61 |
| Chemical | 14.06 |

Source: Company filings.

**Ansell's Business Is Well Positioned for the Long Term Against Competitive Pressures**

We see limited competitive pressure on Ansell’s differentiated products and reiterate its narrow moat rating based on intangible assets. Ansell holds several of the largest and most highly reputable brands in the industries it serves, which are prominently displayed on its products, and has consistently held the highest- or second-highest global market share in each of its key verticals. The proportion of sales generated from its five key differentiated brands has grown to over 80% in fiscal 2022 from 45% in fiscal 2012. This highlights the increasing traction and captivity driven by its key brands and has reduced Ansell’s exposure to its commoditised products such as standard thin single-use exam gloves, where it is neither the market leader nor has a competitive advantage.

The perceived market risk is that new industry capacity built to meet pandemic-induced demand could now be in search of end markets that compete with Ansell’s differentiated products. Given its proprietary formulations of raw materials and manufacturing expertise generated by in-house research and development, Ansell's differentiated products often boast superior protection benefits without compromising durability or fit, but we concede that there are likely many available alternative products and Ansell's technology may be replicable over the next decade. However, in highly skilled industries such as chemical or mining, where wearing the right brand could be the difference between being protected from injury or not, and employee satisfaction depends on fit and preference of gloves, we think it's inherently challenging for smaller, less reputable manufacturers to compete with Ansell's brands that have proven product safety and quality. This is particularly true when protective gloves are likely a sliver of the cost base for Ansell's clients. As an example, this has allowed Ansell to command a 15% price premium in the mechanical subsegment with its Hyflex product range, where customers have responded with loyalty and a willingness to pay a premium. As such, we expect Ansell's key brands to remain strong.

Our unchanged midcycle revenue growth forecast of 3.6% is within Ansell's target range of 3%–5%. This is driven by underlying trends in improved workplace safety and population factors, particularly in emerging markets. Fiscal 2022 sales in emerging markets rose 7% to USD 451 million and now make up 23% of group sales. Here, we see a long runway of growth. Prior to the pandemic, the average American used eight times as many gloves as the average person in Asia. However, we think out of the pandemic, given trends in improved hygiene and safety protocols, the gap in gloves use per capita between emerging and more mature markets will structurally become smaller. Sales volumes grew sequentially in all of Ansell's businesses in second-half fiscal 2022 on the first half, with 15% half-on-half sales growth in the surgical business. In the near-term, we expect Ansell to continue servicing its back orders in surgical gloves as hospitals tackle a backlog of surgeries.

The company is still guiding for fiscal 2023 EPS to decrease to USD 1.15–USD 1.35 following fiscal 2022 EPS of USD 1.37. However, this is mainly due to management anticipating a negative USD 32 million EBIT impact in fiscal 2023, or roughly USD 0.19 in EPS, due to foreign-currency movements. In addition, Ansell has ceased its relatively small commercial and manufacturing operations in Russia, which contributed USD 9 million in fiscal 2022, or roughly USD 0.05 in EPS. Our unchanged fiscal 2023 EPS forecast of USD 1.28 is toward the upper end of Ansell's guidance range.

Given the conservative balance sheet with net debt/EBITDA at 0.9 on June 30, we also keep our 45% dividend payout forecast. We forecast leverage to be under 0.5 over our explicit five-year forecast period and do not expect rising interest rates to materially hit earnings. M

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