14 December 2009

AFFIN INVESTMENT BANK

Company Update

Hai-O Ent

HAIO MK
RM6.99

BUY (maintain)

Target Price: RM8.10(↑)

Price Performance

	1M	3M	12M
Absolute	-12.5%	+33.7%	+131.5%
Rel to KLCI	-11.8%	+28.2%	+58.1%

Stock Data

Issued shares (m)	83.2
Mkt cap (RMm)	581.9
Avg daily vol - 6mth (m)	0.08
52-wk range (RM)	8.05-2.98
Est free float	47.7%
NTA per share (RM) (end-Jul 09)	2.2
P/NTA (x)	3.18
Net cash/debt (RMm) (end-Jul 09)	55.1
ROE (FY10F)	41.1
Derivatives	Nil

Key Shareholders

Tan Kai Hee	9.6%
Akintan Sdn Bhd	7.2%

Earnings & Valuation Revisions

	10E	11E	12E
Prev EPS (sen)	84.7	95.3	105.1
Curr EPS (sen)	89.9	106.8	123.9
Chg (%)	+6.1%	+12.2%	+17.7%
Prev target price (RM)			6.00
Curr target price (RM)			8.10

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Riding high on strong MLM division

Share price up +118% YTD

Hai-O's share price has surged +118% and outperformed the FBM KLCI Index by +52% YTD. We met up with management to get an update on the company.

Distributor force still growing strong, Indonesia MLM expansion on track

Current distributor base in the MLM division numbers at just over 100,000 while new member recruitment averages at 4,000-5,000 per month (previously 2,000-3,000) This is a direct result of stronger A&P activities, which include 1) introducing television ads on local channels and 2) increasing billboard advertisements. We raise our monthly membership additions to 4,000 for FY09 (previously 3,000), 2,000 for FY10 (previously 1,000) and 1,500 for FY11 (previously 1,000). Hai-O also obtained their Indonesian MLM license in Aug 09. We have imputed a more conservative Indonesian distributor base of 2,000 for FY10, 4,000 for FY11 and 8,000 for FY12, translating into bottomline contributions of 2-8%. Taken together with the increase in local monthly member additions, our FY10-12 net earnings forecasts are raised by 6-18%.

Increased but cautious consumer spending to support non-MLM divisions

Overall, MLM sales were less vulnerable to the economic crisis than we had initially expected. The other divisions were not as fortunate, as the wholesale and retail divisions suffered the brunt of cutbacks in consumer spending. Management guided that consumer spending is picking up, albeit cautiously. Going forward, we expect purchases for Chinese New Year to support earnings in the wholesale and retail divisions. We forecast FY10 MLM sales growth of +54.5%, with wholesale and retail divisions registering a lower +3% and +4.9%, respectively (note that the wholesale and retail division account for approximately 20% of total revenue).

Heat transfer technology to be transformed into earnings in 2 years

Management also provided further clarification on Hai-O Energy's tie-up with China's Institute of Engineering Thermophysics (IET). Recall that Hai-O Energy's technical director, Suvit Lee, had discovered a fourth medium of heat transfer. Hai-O has already applied for patents for the technology. We turn positive on developments in Hai-O Energy, post-clarification by management. The new technology is expected to be manifested into a profit-making product in 2 years.

Maintain BUY, with new TP of RM8.10

We switch our valuation methodology from DDM to a PE multiple of 8x on CY10 EPS, representing a 30% discount to our average consumer sector PE of 11.2x. The discount is justified, in our opinion, in view of Hai-O's low trading liquidity. Our target price is hence raised to **RM8.10**. Maintain **BUY**.

Earnings and Valuation Summary

FYE 30 April	2008	2009	2010F	2011F	2012F
Revenue (RMm)	373.8	435.2	628.4	741.6	850.2
EBITDA (RMm)	69.5	84.7	112.2	133.6	153.9
Pretax profit (RMm)	67.7	75.9	109.9	130.6	151.5
Net profit (RMm)	48.5	52.3	75.8	90.2	104.6
EPS (sen)	58.3	61.9	89.9	106.8	123.9
EPS growth (%)	124.2	6.2	45.1	18.9	16.0
PER (x)	12.0	11.3	7.8	6.5	5.6
Core net profit (RMm)	48.5	52.3	75.8	90.2	104.6
Core EPS (sen)	58.3	61.9	89.9	106.8	123.9
Core PER (x)	12.0	11.3	7.8	6.5	5.6
GDPS (sen)	40.0	42.0	54.5	65.0	75.0
Dividend Yield (%)	5.7	6.0	7.8	9.3	10.7
EV/EBITDA (x)	7.2	6.2	4.4	3.4	2.6
Consensus profit (RMm)			67.4	80.6	84.0
Affin/Consensus (x)			1.1	1.1	1.2

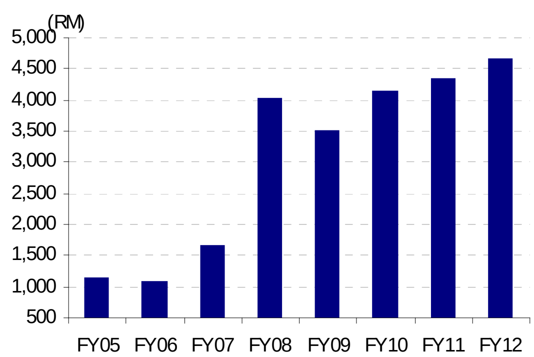
Share price up +118% YTD

Hai-O's share price has surged +118% YTD and outperformed the FBM KLCI Index by +52%. We recently met up with management to get an update on the company.

Distributor force still growing strong

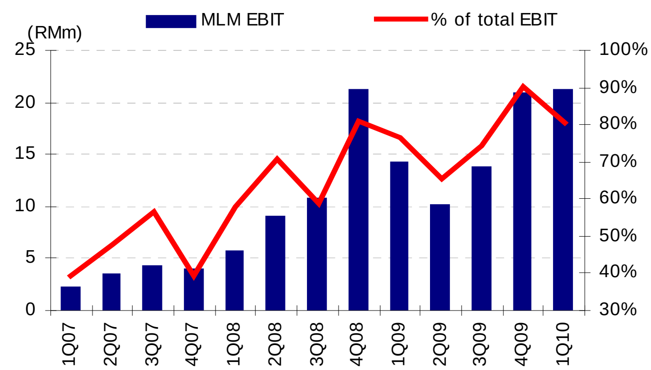
Current distributor base in Hai-O's stronghold, the MLM division has grown to around 100,000 (60% of which are considered 'active', up +66.7% yoy from an estimated 36,000 in 2008.) New members recruitment averages at 4,000-5,000 per month, from 2,000-3,000 previously. The increase in monthly additions is a direct result of stronger A&P activities carried out around Apr-May 09, which includes: 1) introduction of television ads on local channels (geared towards the Bumiputera market, as they account for 90% of total members); and 2) increase in billboard advertisements from 10 to 30. According to management, new additions continue to come from the Bumiputera market, particularly civil servants. We raise our monthly membership additions to 4,000 for FY09 (previously 3,000), 2,000 for FY10 (previously 1,000) and 1,500 for FY11 (previously 1,000).

Fig 1: Average revenue/distributor



Source: Company data, Affin estimates

Fig 2: MLM accounting for a growing proportion of total EBIT



Source: Company data, Affin estimates

MLM expansion to Indonesia on track

Meanwhile, Hai-O's foray into Indonesia has already been set in motion. The company obtained their MLM license in Aug 09 and is targeting 5,000-10,000 members by the end of the first year (currently, there are less than 100 distributors.) Initial investment in Indonesia amounted to US$0.5m, which Hai-O hopes to recover in 2 years. The product range in Indonesia is similar to Malaysia's but prices are higher by 10%, after accounting for import duties and transportation costs. Product packaging is also different to prevent the Malaysian market items from being hand-carried and sold at a cheaper price in the Indonesian market. We have imputed a more conservative distributor base of 2,000 for FY10, 4,000 for FY11 and 8,000 for FY12, translating into bottomline contributions of up to 2%. Taken together with the increase in local monthly member additions, our FY10-12 net earnings forecasts are raised by 6-18%.

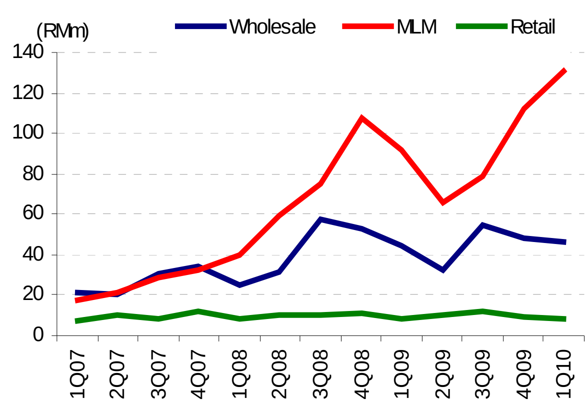
Population numbers point at huge potential in Indonesia

The sheer size of Indonesia's population (2009 IMF estimate: 231.5m) is a gold mine in terms of potential member recruitment. Although IMF ranks Indonesia 116th in terms of GDP/capita (comparatively, Malaysia is ranked 65th), the absolute addressable market of high-income segment is, we believe, still huge. Furthermore, Indonesia's poor water quality ensures demand for Hai-O's star product, the Bio Aura water filtration system.

Improving but cautious consumer spending to support non-MLM division

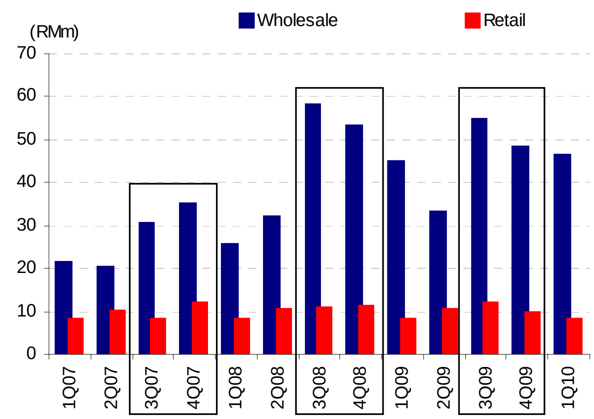
Overall, MLM sales were less vulnerable to the economic crisis than we had initially expected, if 1QFY10's impressive yoy sales growth of +42.4% were any indication. The other divisions were not as fortunate, with the wholesale and retail divisions suffering the brunt of cutbacks in consumer spending. Management guided that consumer spending is picking up, though the key word used to describe consumer behaviour was 'cautious'. Going forward, we expect purchases for Chinese New Year to support earnings in the wholesale and retail divisions. We forecast FY10 MLM sales growth of +54.5%, with wholesale and retail divisions registering a lower +3% and +4.9%, respectively.

Fig 3: Breakdown of revenue for wholesale, MLM and retail divisions



Source: Company data

Fig 4: Wholesale & retail revenue typically higher in 2HFY, inline with Chinese New Year festivities



Source: Company data

Heat transfer technology to be transformed into earnings in 2 years

Management also provided further clarification on Hai-O Energy's tie-up with China's Institute of Engineering Thermophysics (IET) from the Chinese Academy of Sciences. Recall that Hai-O Energy's technical director, Suvit Lee, had "discovered" a fourth medium of heat transfer (the well-known three are conduction, convection and radiation). Essentially, the new technology transfers heat at a faster speed than the currently known 3 mediums, making it practical for use in confined areas with high temperatures. The new technology is expected to be manifested into a profit-making product in approximately 2 years.

Hai-O Energy – potential new growth driver

China's interest in Hai-O Energy is not entirely altruistic – management said that China's own research divisions had reached an obstacle, which they believe can be bridged with the new heat transfer discovery. While Hai-O owns the patent, as well as the technology, they do have a profit-sharing agreement with Mr. Lee. We think it is still early stages in its development, in particular its commercial viability. As such, we refrain from imputing any earnings from the division, as it is still undergoing R&D, but note that the new technology and its implications on earnings is worth keeping an eye on.

Strong earnings track record to continue

Looking ahead, we expect Hai-O to continue its strong earnings track record (net profit has grown at a 3-year FY06-09 CAGR of 72.5%). Supplementary income and the company's attractive overseas incentive trips should spur on MLM distributor activity (note that there are 2 more trips in the offing, likely to Australia and China). Furthermore, Chinese New Year festivities in 2HFY10 would also boost contributions from the wholesale and retail divisions. Management also reaffirmed their dividend payout policy of no less than 50%. Traditionally, Hai-O has paid out above and beyond that amount, averaging at 65% over the past 5 financial years. We project FY10 and FY11 earnings growth of 45.1% and 18.9% and FY10 and FY11 GDPS of 54.5 sen (yield: 7.9%) and 65 sen (yield: 9.4%).

Low risks

Key risks to the stock are: 1) loss of distributors to competitors. Hai-O's main competitors are Zhulian and Amway. However, we believe distributor stickyness is high, thanks to Hai-O's attractive incentive trips and unique products; 2) slowdown in economic recovery momentum. Should the economy dip once again into a recession (unlikely), subsequent cutbacks would hamper earnings contribution from the wholesale and retail divisions; 3) reduction in micro-credit borrowing. Hai-O guided that some of its MLM members take out loans and adopt Hai-O's MLM structure as their own business. Reluctance of banks to approve loans would hold back those more ambitious MLM members. Nevertheless, given the Malaysian government's push in encouraging entrepreneurship and SMEs, we doubt this would curb MLM members from expanding their reach.

Maintain BUY, with new TP of RM8.10

Management indicated that there are no plans for a bonus issue or share split at this juncture to improve Hai-O's trading liquidity. We switch our valuation methodology from DDM to a PE-based target of 8x on CY10 EPS, representing a 30% discount to our average consumer sector PE of 11.2x. The discount is justified, in our opinion, in view of Hai-O's low trading liquidity. Our target price is hence raised to **RM8.10**. Maintain **BUY**. The company is unique given its growth exposure to all mainstream segments of Malaysia's population (retail: Chinese-based, MLM: mainly Malay based).

Focus Charts

Fig 5: MLM sector comparison table

	Rating	Sh Pr (RM)	TP (RM)	Market Cap (RMm)	PER (x) Pros. Yr 1	PER (x) Pros. Yr 2	EPS Growth (%) Pros. Yr 1	EPS Growth (%) Pros. Yr 2	ROE (%) Pros. Yr 1	ROE (%) Pros. Yr 2	Dividend Yield (%) Pros. Yr 1	Dividend Yield (%) Pros. Yr 2
Malaysia												
HAI-O	BUY	6.99	8.10	590.4	6.5	5.6	18.9	16.0	37.1	33.6	9.3	10.7
AMWAY	NR	7.30	na	1,200.0	13.4	13.0	(9.9)	(2.9)	31.7	35.7	7.0	7.1
ZHULIAN	NR	1.53	na	527.9	5.9	na	(11.5)	na	na	na	8.5	na
Simple average					**8.6**	**9.3**			**34.4**	**34.7**	**8.3**	**8.9**

Source: Bloomberg, Affin

Fig 6: Consumer sector peer comparison table

Stock	Rating	Sh Pr (RM)	TP (RM)	Mkt Cap (RMm)	Year end	Core PE (x) Pros1	Core PE (x) Pros2	EPS growth (%) Pros1	EPS growth (%) Pros2	EV/EBITDA (x)	P/B (x)	ROE (%) Pros1	ROE (%) Pros2	Div. Yield (%) Pros1	Div. Yield (%) Pros2
AEON	REDUCE	4.90	4.45	1,720	Dec	12.1	11.0	14.3	10.6	5.1	1.8	13.8	13.8	3.1	3.1
BAT	ADD	42.96	48.70	12,266	Dec	16.3	15.6	-2.7	4.6	1.0	254.1	156.7	134.6	5.8	5.9
BONIA	REDUCE	1.00	0.95	202	Jun	7.2	6.4	6.8	11.5	3.4	0.9	13.1	13.1	3.0	3.0
CARLSBERG	BUY	4.50	5.30	1,376	Dec	11.7	10.7	46.3	9.5	11.1	6.5	21.4	21.3	6.3	6.3
GUINNESS	BUY	6.90	7.50	2,084	Jun	13.1	12.3	5.2	7.2	8.8	4.5	32.5	32.2	5.9	6.5
HAI-O	BUY	6.99	8.10	590	Apr	6.5	5.6	18.9	16.0	4.3	2.9	37.1	33.6	9.3	10.7
JTI	ADD	4.81	5.00	1,258	Dec	11.5	10.9	1.0	5.3	6.8	4.0	30.8	26.0	6.2	6.2
Simple average						**11.2**	**10.3**	**12.8**	**9.2**	**5.8**	**39.2**	**43.6**	**39.2**	**5.7**	**6.0**

Source: Bloomberg, Affin

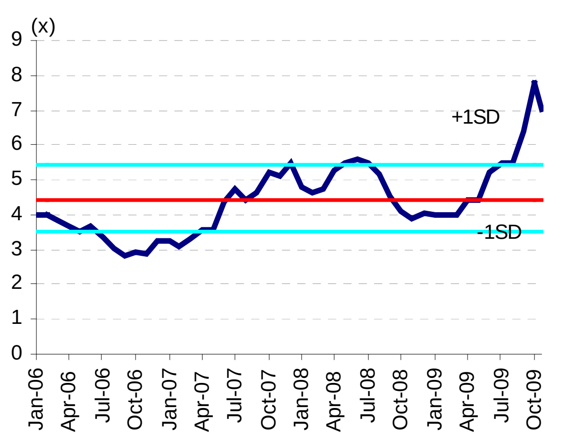
Fig 7: YTD price performance

Source: Bloomberg

Fig 8: YTD price performance relative to KLCI

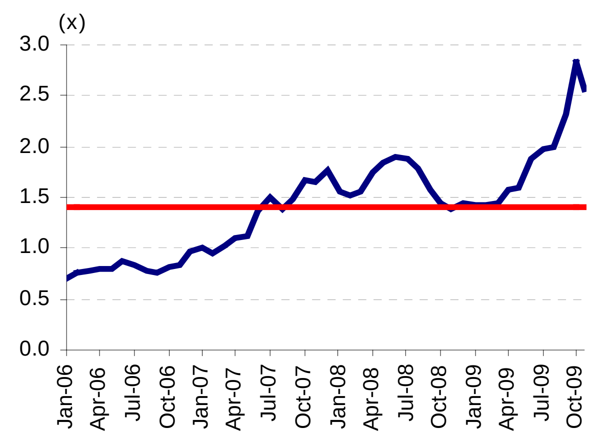
Source: Bloomberg

Fig 9: Forward P/E



Source: Bloomberg, Company data, Affin

Fig 10: Forward P/B



Source: Bloomberg, Company data, Affin

Hai-O Enterprise – Financial Summary

Profit & Loss Statement

FYE 30 April (RMm)	2008	2009E	2010E	2011E	2012E
Revenue	373.8	435.2	628.4	741.6	850.2
Operating expenses	-304.4	-350.5	-516.2	-608.0	-696.3
EBITDA	69.5	84.7	112.2	133.6	153.9
Depreciation	-2.2	-7.7	-4.0	-4.1	-4.2
EBIT	68.1	77.0	108.2	129.5	149.7
Net int income/(expense)	0.5	-1.2	1.7	1.1	1.8
Associates' contribution	0.0	0.0	0.0	0.0	0.0
Pretax profit	67.7	75.9	109.9	130.6	151.5
Tax	-18.7	-22.9	-33.0	-39.2	-45.5
Minority interest	-0.6	-0.7	-1.1	-1.3	-1.5
Net profit	48.5	52.3	75.8	90.2	104.6

Balance Sheet Statement

FYE 30 April (RMm)	2008	2009E	2010E	2011E	2012E
Fixed assets	21.6	59.4	58.5	57.4	56.2
Other long term assets	28.6	34.7	34.2	33.7	33.2
Total non-current assets	**50.2**	**94.2**	**92.7**	**91.1**	**89.4**
Cash and equivalents	73.6	51.0	101.7	144.2	195.0
Stocks	41.4	36.2	56.0	66.1	75.8
Debtors	25.7	36.3	44.7	52.8	60.5
Other current assets	13.6	30.8	13.4	13.4	13.4
Total current assets	**154.3**	**154.3**	**215.9**	**276.6**	**344.7**
Creditors	39.4	47.1	66.5	78.5	89.7
Short term borrowings	5.2	3.7	3.7	3.7	3.7
Other current liabilities	13.4	9.5	13.5	15.5	17.6
Total current liabilities	**58.0**	**60.4**	**83.8**	**97.8**	**111.0**
Long term borrowings	0.0	15.7	15.7	15.7	15.7
Other long term liabilities	0.1	0.1	0.1	0.1	0.1
Total long term liabilities	**0.1**	**15.8**	**15.8**	**15.8**	**15.8**
Shareholders' Funds	**140.6**	**165.7**	**203.2**	**248.8**	**302.8**
Minority interest	**5.5**	**6.3**	**5.8**	**5.1**	**4.3**

**Changes in accounting policies to FRS 134*

Cash Flow Statement

FYE 30 April (RMm)	2008	2009E	2010E	2011E	2012E
EBIT	67.7	75.9	109.9	130.6	151.5
Depreciation & amortisation	2.2	7.7	4.0	4.1	4.2
Working capital changes	19.8	-18.7	12.5	-4.1	-4.2
Cash tax paid	-18.7	-24.5	-33.0	-39.2	-45.5
Others	-13.1	12.3	-7.4	-7.0	-6.7
Cashflow from operation	**57.9**	**52.7**	**86.1**	**84.5**	**99.4**
Capex	-1.8	-39.7	-2.5	-2.5	-2.5
Others	0.0	1.0	0.0	0.0	0.0
Cash flow from investing	**-1.8**	**-38.7**	**-2.5**	**-2.5**	**-2.5**
Debt raised/(repaid)	-2.2	6.0	0.0	0.0	0.0
Dividends paid	-24.6	-26.5	-33.1	-39.5	-45.6
Others	1.5	2.5	1.7	1.1	1.8
Cash flow from financing	**-25.3**	**-17.9**	**-31.4**	**-38.4**	**-43.8**
Free Cash Flow	**56.1**	**13.0**	**83.6**	**82.0**	**96.9**

Key Financial Ratios and Margins

FYE 30 April (RMm)	2008	2009E	2010E	2011E	2012E
Growth					
Revenue (%)	97.4	16.4	44.4	18.0	14.6
EBITDA (%)	112.8	21.9	32.4	19.1	15.2
Core net profit (%)	126.6	7.9	45.0	18.9	16.0
Profitability					
EBITDA margin (%)	18.6	19.5	17.9	18.0	18.1
PBT margin (%)	18.1	17.4	17.5	17.6	17.8
Net profit margin (%)	13.0	12.0	12.1	12.2	12.3
Effective tax rate (%)	27.6	30.1	30.0	30.0	30.0
ROA (%)	27.5	24.5	27.6	27.0	26.1
Core ROE (%)	39.4	34.1	41.1	39.9	37.9
ROCE (%)	52.6	46.6	53.1	52.8	50.7
Dividend payout ratio (%)	68.6	66.6	60.7	60.9	60.5
Liquidity					
Current ratio (x)	2.7	2.6	2.6	2.8	3.1
Op. cash flow (RMm)	57.9	52.7	86.1	84.5	99.4
Free cashflow (RMm)	56.1	13.0	83.6	82.0	96.9
FCF/share (sen)	67.5	15.3	99.0	97.1	114.8
Asset management					
Debtors turnover (days)	30.3	34.0	30.6	27.9	26.0
Stock turnover (days)	45.2	40.4	32.6	36.7	37.2
Creditors turnover (days)	36.6	45.0	40.2	43.5	44.1
Capital structure					
Net gearing (%)	net cash	net cash	net cash	net cash	net cash
Interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.

Quarterly Profit & Loss

FYE 30 April (RMm)	1Q09	2Q09	3Q09	4Q09	1Q10
Revenue	112.9	87.3	102.1	132.8	148.6
Operating expenses	-94.3	-71.8	-83.5	-109.8	-122.3
EBITDA	18.6	15.5	18.6	23.0	26.3
Depreciation	0.0	0.0	0.0	0.0	0.0
EBIT	18.6	15.5	18.6	23.0	26.3
Net int income/(expense)	0.1	-0.2	-0.1	-0.1	0.0
Associates' contribution	0.0	0.0	0.0	0.0	0.0
Exceptional Items	0.0	0.0	0.0	0.0	0.0
Pretax profit	18.7	15.3	18.6	23.0	26.3
Tax	-5.1	-4.2	-6.2	-8.2	-7.8
Minority interest	0.0	-0.2	-0.4	-0.1	-0.1
Net profit	13.6	10.9	12.0	14.7	18.5
Core net profit	13.6	10.9	12.0	14.7	18.5
Margins (%)					
EBITDA	16.5	17.8	18.2	17.3	17.7
PBT	16.6	17.6	18.2	17.3	17.7
Net profit	12.0	12.5	11.7	11.0	12.4

Source: Company data and Affin Investment Bank estimates

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +15% over a 12-month period
TRADING BUY (TR BUY)	Total return is expected to exceed +15% over a 3-month period due to short-term positive development, but fundamentals are not strong enough to warrant a Buy call. This is to cater to investors who are willing to take on higher risks
ADD	Total return is expected to be between 0% to +15% over a 12-month period
REDUCE	Total return is expected to be between 0% to -15% over a 12-month period
TRADING SELL (TR SELL)	Total return is expected to exceed -15% over a 3-month period due to short-term negative development, but fundamentals are strong enough to avoid a Sell call. This is to cater to investors who are willing to take on higher risks
SELL	Total return is expected to be below -15% over a 12-month period
NOT RATED	Affin Investment Bank does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation
OVERWEIGHT	Industry, as defined by the analyst's coverage universe, is expected to outperform the KLCI benchmark over the next 12 months
NEUTRAL	Industry, as defined by the analyst's coverage universe, is expected to perform inline with the KLCI benchmark over the next 12 months
UNDERWEIGHT	Industry, as defined by the analyst's coverage universe is expected to under-perform the KLCI benchmark over the next 12 months

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