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OSK

MALAYSIA EQUITY
Investment Research
Daily News

Company Update

Private Circulation Only

CONSUMER

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Hai-O

BUY	**Maintain**
Price	**RM3.24**
Target	**RM4.16**

Weathering the Storm

While the depreciating Ringgit against the US$ would dampen 3QFY09 earnings, Hai-O should be able to weather the economic downturn relatively well given its exposure to healthcare products, which are considered defensive. It is worth noting that Hai-O remained profitable even during the last Asian financial crisis. The stock offers a compelling dividend yield exceeding 10%.

Prospects still promising. Despite the sluggish economic conditions, we are still positive on the group's earnings prospects due to (i) its exposure to health food, which is recession-proof; (ii) its MLM (multi-level marketing) division, for which there is room to grow given that it targets the bumiputra market, and given the increasing number of members and introduction of new products; and (iii) the retail division, supported by a strong customer loyalty programme, will still report good sales at least until the Chinese New year festive season. Although its earnings dropped 45% to RM5.3m in 1998, we expect the company to be able to weather the storm better this time around given its better business structure with the disposal of its non-performing businesses and having different divisions targeting different market segments.

Venturing into Indonesia and China. As highlighted in our report dated Dec 18 2008, the group will kickstart its successful MLM business in Indonesia starting Mar '09. It has also incorporated a subsidiary in China for the purpose of importing/exporting and distributing Hai-O products in the domestic market. While we are positive on these ventures given the wide addressable markets, no material contributions are expected over the medium term owing to the gestation period of the start-up and brand-building efforts.

The bite of currency fluctuation. While we are concerned over the impact of the depreciating Ringgit vs the US dollar on group earnings given that 40% of Hai-O's raw materials are transacted in US$, our house view is that the RM will strengthen to RM3.45-RM3.50 and RM3.40-RM3.45 in '09 and '10 respectively. Based on our analysis, a 5 sen drop in the ringgit against the dollar would cut our forecast earnings by 0.8%.

Maintain BUY. We believe the business involving the sale of healthcare-related products is rather resilient and the group is committed to a 50% payout ratio. Furthermore, factoring in the worst-case assumptions, this will affect our FY09 forecast earnings by 28.9%, translating into RM35.3m, well above its earnings of RM21.4m in 2007. We are valuing the stock at RM4.16, pegging it at 7x CY09 EPS.

Stock Profile/Statistics

Bloomberg Ticker	HAIO EQUITY
KLCI	913.70
Issued Share Capital (m)	84.46
Market Capitalisation (RMm)	273.64
52 week H | L Price (RM)	3.90 | 2.61
Average Volume (3m) '000	100.42
YTD Returns (%)	0.04
Net gearing (x)	-0.56
Altman Z-Score	5.64
ROCE/WACC	2.94
Beta (x)	0.91
Book Value/share (RM)	1.76

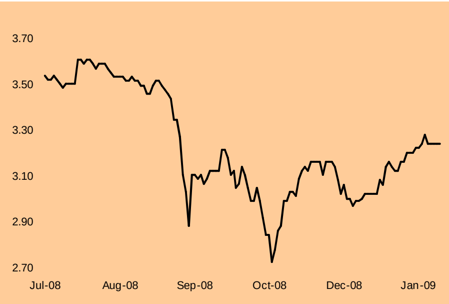
Major Shareholders (%)

Kait Hee Tan	9.59
Akintan SB	7.00
Excellent communication	5.11

Share Performance (%)

Month	Absolute	Relative
1m	7.29	0.07
3m	8.38	1.35
6m	-5.59	6.54
12m	15.88	70.48

6-month Share Price Performance



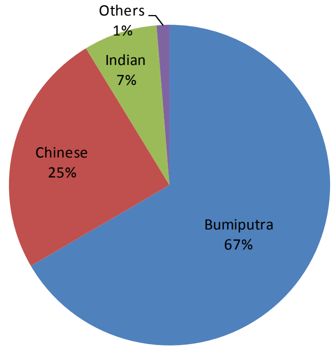
Hai-O is involved in wholesaling, retailing, multi-level marketing, and operates a pharmaceutical factory and modern Chinese medicinal clinics.

FYE Apr (RM m)	FY06	FY07	FY08	FY09f	FY10f
Turnover	144.3	189.3	373.8	387.5	406.3
Net Profit	10.2	21.4	48.5	49.6	50.4
% chg YoY	85	110	127	2	2
Consensus	-	-	-	50.3	54.0
EPS (sen)	12.1	25.3	57.5	58.7	59.7
DPS (sen)	8.0	18.0	40.0	40.0	40.0
Div Yield	2.5	5.6	12.3	12.3	12.3
ROE	11.4	20.2	34.5	31.7	29.1
ROA	8.1	14.4	23.8	22.3	21.2
PER (x)	26.9	12.8	5.6	5.5	5.4
P/BV (x)	3.1	2.6	1.9	1.7	1.6
EV/EBITDA (x)	15.0	7.6	2.9	2.6	2.4

KEY HIGHLIGHTS

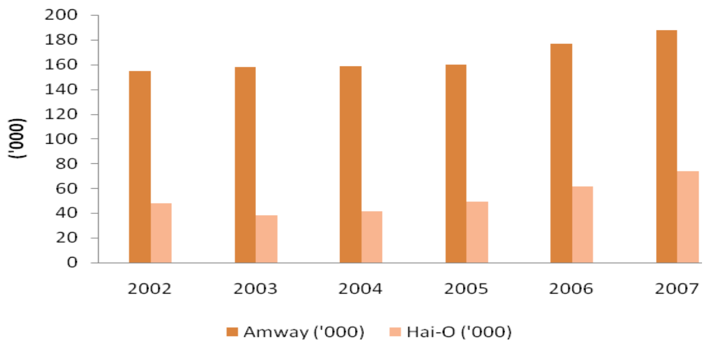
Targeting the right segment. Despite the current poor economic conditions which would eventually dampen consumer spending, we are still positive on the company's MLM division given that 90% of its MLM customers are bumiputras, of whom the majority are civil servants. This customer segment with relatively stronger buying propensity is less likely to be affected by the economic downturn as we believe that the Government would provide a safety net for them. Furthermore, with the availability of the halal certification on certain products and the fact that bumiputras comprise 67% of the country's population, the group is targeting the right segment and thus, there is ample room for its MLM business to grow. Having said that, it is undeniable that although the total disposable income remains intact, consumer spending per capita is expected to shrink owing to psychological effects as more negative news flow in from overseas. This would, however, help to boost the number of MLM members as people look for second jobs given the difficult economic environment and compensate for the lower revenue contribution per MLM member. Hai-O's total MLM membership of 80,000 is a far cry from Amway, which has ~180,000 members. We think there is still room to grow given that 90% of the members are bumiputras and that its 80,000 members only account for 0.5% of the country's bumiputra population.

Figure 1: Malaysia population breakdown



Source: OSK

Figure 2: Comparison of number of MLM members of Hai-O and Amway



Source: OSK

Margin compression likely. On a less positive note, as the tough economic conditions cause consumers to divert spending from purchasing its high margin and sellable products such as Hai-O's Bio Aura water purifiers and slimming lingerie, we should see margin compression in the coming months. We are projecting for its MLM division to grow by a CAGR of 7.8% on the assumption that the number of members will grow at a CAGR of 10% but revenue contribution per member will fall 5%-10% in the next two years. To further determine the impact of slower consumer spending on its MLM division, we had carried out a sensitivity analysis. In a worst-case scenario, should MLM revenue decrease by a further 30% on top of the 5%-10% drop that we have factored in, our FY09 and FY10 estimated earnings would drop by ~24%.

Figure 3: Sensitivity analysis of the impact on earnings on lower revenue contribution from MLM division

	2009f			
Further decrease in revenue per distributor	**0.0%**	**-10%**	**-20%**	**-30%**
Number of members	90,000	90,000	90,000	90,000
Total revenue	292.4	263.2	233.9	204.7
% impact on earnings	0.0%	-8.1%	-15.9%	-23.8%

	2010f			
Further decrease in revenue per distributor	**0.0%**	**-10%**	**-20%**	**-30%**
Number of members	100,000	100,000	100,000	100,000
Total revenue	308.7	277.8	246.9	216.1
% impact on earnings	0.0%	-7.9%	-16.1%	-24.0%

Source: OSK

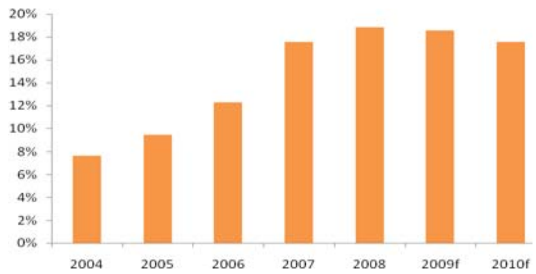
Making inroads in Indonesia. It has been a while since Hai-O announced plans to venture to Indonesia. We understand that preliminary work has already been undertaken and a local partner identified. Only the approvals of the relevant procedures are pending. It is estimated that the business will kick-start in March '09. Given its attractive incentives and the minimal CAPEX needed, Indonesia's population of 237.512m, or equivalent to 9 times Malaysia's population, and both countries' similar demographics and culture, we believe Hai-O can successfully replicate its MLM business in Indonesia in the long term. In the short term, however, we are cautious as building a strong brand and network and beating the local rivals would be tough initially. In addition, the purchasing power in Indonesia is not as strong as that of Malaysian consumers as the country's unemployment rate is at a high of 9% vs Malaysia's 3%. Besides, more than 60% of the population is in the low-mid segment whose buying power would be eroded by the economic crisis. To err on the side of conservatism, we have yet to compute any contribution from Indonesia into our forecast.

Products in the pipeline. Hai-O had just launched a series of health food supplements (see figure 4) for its MLM division in this month and we gather that these products are well accepted by the public. Other than this, the group is also introducing a new product, notably anti-aging skin care product in Jan '09 to fuel MLM's products' range. This new product which is priced at ~RM500/set will be manufactured locally using material imported from Switzerland. While this may boost sales to a certain extent, we still think that its two main revenue contributors, water purifiers and slimming lingerie will continue to drive the growth of the MLM division as distributors would prefer to promote these products in view of its higher commission base. The group will continue to introduce more house brand products (which now accounts for 70-80% of the total products) going forward as it commands a significant higher margin compared to that of pure distribution. Since the group started to introduce more house brand products in 2006, margins have gone up considerably from 7.6% in FY04 to 18.8% in FY08 (see Figure 5).

Figure 4: Hai-O's newly-launched health food supplements

Source: OSK

Figure 5: EBITDA margin



Source: OSK

Retail division will still perform. Retail division accounts for 10.5% (as in FY08) of the total group revenue and we remain upbeat on this division at least until the next quarter as the Chinese purchase gifts for Chinese New Year festivities. In our view, its business which is involved in selling healthcare products is rather resilient and we are not too concerned that consumers would down-trade and opt for the cheaper products in other traditional medicine halls as we believe that there is certain brand loyalty for its products. This has been proven by its ever increasing Hai-O Raya Customer Loyalty Program's number of members, which has reached 120,000 and contributes over 50% to the total retail sales. Assuming that non-member customers down-trade and it loses 40% of the revenue, this would impact on our forecast FY09 and FY10 earnings by a minimal 6.7% and 5.2% respectively. Its presence in high traffic locations such as shopping malls as opposed to the other traditional medicine halls would also continue to attract customers. The group currently owns 60 outlets vs its main competitor Eu Yan Sang's 56 outlets. To defend its position as the largest chain store in Malaysia, Hai-O is committed to open 2 to 3 new outlets annually.

JV sales still resilient. Management alluded that the sales performance of its JV with Tong Ren Tang and Sanjiu Enterprise Group is still resilient. On top of the existing outlets, the group plans to open another new outlet for the former in Johor Baru. While the contribution of the JVs is still small at about RM1-2m/year, Hai-O can tap on the two companies' strong names to attract different customer segments such as Chinese immigrants. Tong Ren Tang was established sometime during the Qing dynasty in 1669 while Sanjiu Enterprise Group is one of China's largest modern herbal product manufacturers.

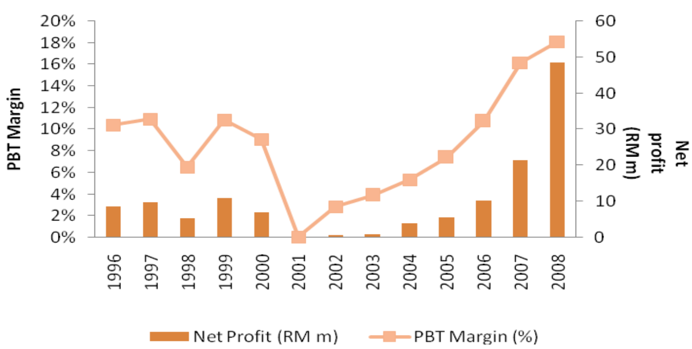
Figure 6: JVs' outlets with Tong Ren Tang and Sanjiu Enterprise Group

Source: OSK

China subsidiary. In December '08, Hai-O incorporated a subsidiary company, Hai-O (Guangzhou) Trading Ltd in China vide its wholly owned subsidiary, Hai-O (Hong Kong) Investment Limited, for the purpose of importing/exporting and distributing Hai-O products in the domestic market. Although this is only at the initial stage, we see this as an opportunity for the group to gain a foothold in China, which is a readily accessible market where Chinese medicine is widely accepted. Previously, the group had made known its intention to export its own local brand products such as Tongkat Ali Coffee and bird's nest as well as introduce a vitamin supplement known as "Tri E" to China. To recap, in October '07 Hai-O entered into a distributorship agreement with Golden Hope Bioganic S/B to distribute and sell Tri-E (a soft gel capsule of Vitamin E extract from palm oil) to China, excluding Hong Kong and Macau, for a period of 3 years. While the company is still in talks with several retailers which have wide distribution networks in China, we understand that this plan has been put on hold pending approvals and further information from Golden Hope.

Still profitable during Asian financial crisis. A check on Hai-O's historical financial results showed that the group posted a net loss of RM2.3m in 2001 but remained profitable during the Asian financial crisis although earnings fell to RM5.25m in 1998 from RM9.64m in the previous year. Nevertheless, its earnings rebounded very quickly in 1999. The negative earnings in 2001 were attributed to the lower turnover at its MLM division, share losses from its overseas associates and the discontinuation of two overseas operating units. We opine that the company's earnings would not be hit as much as previously by the current adverse situation, as its stalwart MLM division is helmed mostly by bumiputras (unlike before when the members and customers were mostly Chinese). The group also stands to reap the benefits from its restructuring involving the disposal its non-core assets and non-performing businesses in the past few years. We understand that all its divisions performed well in November and December '08, except for the manufacturing division, which is facing a slight slowdown.

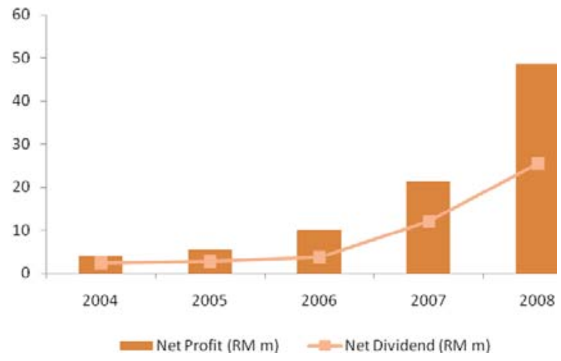
Figure 7: Historical net profit and PBT margin



Source: OSK

Rewarding shareholders. Hai-O is committed to a 50% payout ratio and has in fact been paying more than 50% of its net profit as dividend over the last 2 years. Management said the group does not see any reason to reduce the payout going forward unless there are capital needs for expansion. In our view, based on its historical payout track record and considerably strong cash position of RM47.9m, Hai-O would be able to continue with its 50% payout policy.

Figure 8: Dividend payout ratio



Source: OSK

Impact of RM against US$ on the group's earnings. While we are concerned that a depreciating ringgit against the US dollar would affect the group's earnings as 40% of its raw materials are transacted in dollars while 100% of its revenue is in RM, our house view is that ringgit will strengthen to RM3.45–RM3.50 and RM3.40-RM3.45 in '09 and '10 respectively. The table below shows our analysis of the impact of the dollar's movements against the local unit on the group's net profit. In a worst-case scenario, should all the worst-case assumptions materialise, i.e. the MLM division experiences a 30% fall in sales, retail sales drop 40% and the ringgit falls 5 sen against the US dollar, this will negatively impact on our FY09 forecast earnings by 28%, which will translate into a net profit of RM35.3m, which is still well above the company's net profit of RM21.4m recorded in FY07.

Figure 9: Sensitivity analysis of the impact of US$-RM movement on Hai-O's net profit

US$-RM	3.35	3.4	3.45	3.5
% impact on FY09 forecast net profit	1.8%	0.8%	0.0%	-0.8%
% impact on FY10 forecast net profit	0.8%	0.0%	0.8%	1.8%

Source: OSK

Figure 10: Comparison of the worst-case assumptions and current assumptions

	Worst case assumptions	Current assumptions
	Revenue	
Wholesale	49.9	49.9
MLM	204.7	292.4
Number of members	90,000	90,000
Turnover per distributor	2274.4	3249.1
Retail	25.0	41.7
Retail space (sf)	65,000	65,000
revenue/sf	384.7	641.2
Other divisions	3.5	3.5
Cost of sales	254.8	254.2
Currency assumption	3.5	3.45
Net profit	**35.3**	**49.6**

Source: OSK

FINANCIAL TABLE

FYE Apr (RMm)	FY06	FY07	FY08	FY09f	FY10f
Turnover	144.3	189.3	373.8	387.5	406.3
EBITDA	17.7	33.2	70.3	71.9	72.5
PBT	15.1	30.6	67.7	69.2	69.9
Net profit	10.2	21.4	48.5	49.6	50.4
EPS	12.1	25.3	57.5	58.7	59.7
DPS	8.0	18.0	40.0	40.0	40.0
Margin					
EBITDA	12.2	17.5	18.8	18.5	17.8
PBT	10.5	16.2	18.1	17.9	17.2
Net Profit	7.1	11.3	13.0	12.8	12.4
ROE	11.4	20.2	34.5	31.7	29.1
ROA	8.1	14.4	23.8	22.3	21.2
Balance sheet					
Fixed asset	45.0	22.0	21.6	21.6	21.6
Current Assets	70.6	95.1	154.0	175.2	189.8
Total Assets	125.2	149.0	204.1	222.8	237.4
Current liabilities	31.2	38.0	58.0	61.2	59.3
Net Current Assets	94.0	110.9	146.2	161.5	178.1
LT Liabilities	-0.2	0.1	0.1	0.1	0.1
Shareholders Funds	89.4	105.7	140.6	156.4	173.0
Net Gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

OSK Research Guide to Investment Ratings

Buy: Share price may exceed 10% over the next 12 months

Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain

Neutral: Share price may fall within the range of +/- 10% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels

Sell: Share price may fall by more than 10% over the next 12 months

Not Rated: Stock is not within regular research coverage

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