

Corporate Highlights



RHB Research Institute Sdn Bhd
A member of the RHB Banking Group
Company No: 233327 -M

Results/ Visit Note

19 December 2008

Hai-O Enterprise

1HFY04/09 Net Profit Lower From Lower MLM Distributor Productivity

Share Price : RM3.06
Fair Value : RM4.16
Recom : **Outperform**
(Maintained)

Table 1 : Investment Statistics (HAIO; Code: 7668)

Bloomberg: HAIO MK

FYE	Net					Net				
	Revenue (RMm)	Profit (RMm)	EPS (sen)	Growth (%)	PER (x)	C. EPS * (sen)	P/NTA (x)	ROE (%)	Gearing (x)	GDY (%)
2008a	373.8	48.5	58.4	121.3	5.2		1.7	11.0	Net cash	10.6
2009f	406.9	46.8	56.4	-3.5	5.4	59.0	2.0	19.7	Net cash	9.3
2010f	438.7	50.6	60.8	8.0	5.0	63.0	2.4	15.1	Net cash	10.1
2011f	492.2	57.7	69.5	14.2	4.3	74.0	2.9	13.6	Net cash	11.5

Main Board Listing / Trustee Stock / Syariah-Approved Stock By The SC

* Consensus Based On IBES Estimates

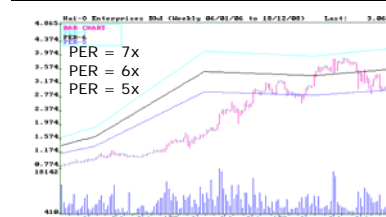
- ◆ **Below expectation.** 1HFY04/09 net profit came in within market forecast but below our expectation, accounting for only 46.9% of our full year forecast. We believe the variance against our forecast came largely from: (1) Lower-than-expected distributor productivity at the MLM division; and (2) Higher-than-expected net interest expense.
- ◆ **1HFY04/09 net profit rose 51.6% yoy** to RM24.5m and this was mainly attributed to: (1) A 4.3% pts increase in EBIT margin at the wholesale and retail division to 21.3% on the back of a better product mix; and (2) A 58.1% increase in revenue contribution at the MLM division, which filtered down to a 0.7% pt increase in EBIT margin to 15.5%. We believe the stellar performance at the MLM division was mainly due to a growth in distributor sales force as well as increased popularity of its two main house brand products.
- ◆ **2QFY04/09 net profit declined by 28.2% qoq** to RM13.6m. This was mainly due to Ramadhan festive season in Oct-08, which affected distributor productivity at the MLM division, although this was offset by higher earnings contribution at the wholesale division.
- ◆ **We garnered a few key takeaways from our company visit** yesterday: (1) MLM distributor force still growing; (2) Retail sales expected to be flat; and (3) "Tea" problem with wholesale division.
- ◆ **Risks.** The risks include: (1) Termination of supply agreements from its suppliers in China; and (2) Contraction in consumer spending in Malaysia.
- ◆ **Forecasts.** We have revised our FY09-11 forecasts downwards by 10.4-13.0% to RM47-58m to reflect lower distributor productivity, lower retail sales per outlet growth and lower sales from wholesale division.
- ◆ **Investment case.** Indicative fair value for Hai-O has been reduced to RM4.16 (from RM4.74), based on unchanged 7x CY09 EPS, representing a 40% discount to our target PE for the consumer sector on account of its small market capitalisation. Maintain **Outperform**.

RHBRI	Vs.	Consensus
✓	Above	
	In Line	✓
	Below	

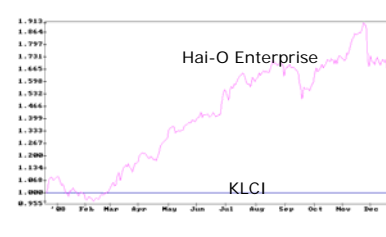
Issued Capital (m shares)	84.4
Market Cap(RMm)	258.4
Daily Trading Vol (m shs)	0.1
52wk Price Range (RM)	2.61 – 3.90
Major Shareholders:	(%)
Tan Family	25.0
Excellent Communication	5.2

FYE Apr	FY09	FY10	FY11
EPS chg (%)	(10.4)	(13.2)	(11.9)
Var to Cons (%)	(4.5)	(3.4)	(6.1)

PE Band



Relative Performance To KLCI



Please read important disclosures at the end of this report.

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Table 2: Earnings Reviews (YoY Cumulative)

FYE Apr (RMm)	2Q08	1Q09	2Q09	QoQ (%)	YoY (%)	6M08	6M09	YoY (%)	Comments
Revenue	80.5	112.9	87.3	-22.7	8.4	139.8	200.2	43.2	Mainly due to higher revenue contribution from the MLM division. Decline qoq due to Ramadhan festive season that affected MLM sales.
- Wholesale & retail	20.1	20.2	20.2	-0.2	0.3	38.6	40.4	4.7	
- MLM	59.5	91.5	65.9	-28.0	10.8	99.6	157.4	58.1	
- Others	0.8	1.2	1.2	6.6	54.1	1.7	2.4	44.8	
EBIT	12.9	18.6	15.5	-16.4	20.4	22.7	34.1	50.2	Filtered down from revenue.
Interest income/(expense)	0.1	0.1	-0.2	-245.9	-274.5	0.1	-0.1	-141.8	
PBT	13.0	18.7	15.3	-17.9	18.1	22.8	34.0	49.0	Filtered down from EBIT.
Taxation	-3.6	-5.1	-4.2	-18.0	16.0	-6.5	-9.3	43.7	
MI	-0.3	0.0	-0.3	nm	-5.7	-0.2	-0.2	18.1	
Net profit	9.1	13.6	10.9	-19.9	19.7	16.2	24.5	51.6	
EPS (sen)	13.6	16.8	13.1	-22.3	-3.6	24.1	30.1	25.0	
Gross dividend (sen)	8.0	0.0	0.0	nm	nm	8.0	0.0	nm	
EBIT margin (%)	16.0	16.4	17.8	1.3	1.8	16.2	17.0	0.8	Driven by margin expansion at both MLM and wholesale divisions.
PBT margin (%)	16.1	16.5	17.6	1.0	1.4	16.3	17.0	0.7	
Net profit margin (%)	11.3	12.0	12.5	0.4	1.2	11.6	12.2	0.7	Boosted further by lower effective tax rate.
Effective tax rate (%)	27.8	27.3	27.3	0.0	-0.5	28.3	27.3	-1.0	

Source: Company; RHBRI

- ◆ **We garnered a few key takeaways from our company visit** yesterday: (1) MLM distributor force still growing; (2) Retail sales expected to be flat; and (3) "Tea" problem with wholesale division.
- ◆ **MLM distributor force still growing...** Year-to-date, Hai-O's distributor force has increased by about 14% to 80,000, with active membership of about 20%. However, due to the petrol price hike, the effects of the economic downturn and Ramadhan festive season, Hai-O has experienced a cumulative drop in sales per distributor of about 20% yoy during the months of September and October, which had a negative impact on its 2QFY09 results. Based on our estimates, in 2QFY09, Hai-O's sales per distributor fell 10% year-to-date. Nevertheless, we expect recent reductions in petrol price, the festive season as well as launch of new products (like the food supplement, Nurich, to be launched this weekend) to help Hai-O's MLM sales improve in the 2HFY09. Management has indicated that its MLM sales have picked up in November, while it continues to aggressively launch new products to generate sales. Another upcoming launch includes a range of anti-aging skin care products, targeted to be launched in February 2009. We have reduced our projections for the MLM division, assuming distributor productivity to decline by 2-4% p.a. (from +3% p.a. previously) for FY09-11. We leave our projected distributor growth numbers at 10-12K p.a. for FY09-11.
- ◆ **... while retail sales expected to be flat.** Hai-O's retail outlets have expanded to 60 (including 11 franchise outlets) year-to-date from 57 outlets at end-FY08 and management intends to open an additional 1-2 outlets by end FY09. After taking into account a weaker 3rd quarter (due to inflationary pressures from the petrol price hike) and a stronger 4th quarter (due to festive sales during Chinese New Year), we expect retail sales to be flat yoy. As such, we reduce our retail sales per outlet growth to 1-2% p.a. for FY09-11 (from 2% previously).
- ◆ **"Tea" problem with wholesale division.** Reuters has reported on 10 December 2008, that the price of Pu-erh tea has crashed under the weight of overproduction and a vastly diminished appetite for exotic investment assets. Industry watchers have indicated that the tea has shed 85% of its value since peaking in May 2007. According to management, sales of Pu-erh tea, which contributed about RM15m p.a. to its wholesale division in the past 2 years has dropped to about RM2-3m (due to lower sales volumes and selling price) in FY09. We have therefore revised our sales projections for Hai-O's wholesale division to take this into account, reducing our FY09 wholesale division revenue by 22%. However, we maintain our FY10-11 revenue growth at 3% p.a.
- ◆ **More on Pu-erh tea.** Recall that previously, Kumpulan Sentiasa Cemerlang (KSC) has launched a Restricted Investment Scheme (RIS) 3-year closed-end fund, whereby Hai-O would source, store and sell the Pu-erh tea, using funds raised by KSC. So far, the fund has acquired RM10.7m (cost) worth of Pu-erh tea. In the agreement, KSC has the right to exercise its put option and on the Pu-erh tea, to sell back the tea at cost to Hai-O, at the end

of the fund's 3 years investment period. We believe KSC has already approached Hai-O regarding this put option that the two parties are in the midst of negotiations currently. Given that the price of Pu-erh tea has come down substantially, Hai-O could be at risk, if KSC decides to exercise its put option and dissolve the fund (with SC's approval), given that its clients may want to redeem their investments. While this may have a short-term negative impact on Hai-O's cashflow and asset value, we believe the value of the tea will recover in the long-term and that Hai-O's balance sheet will not be too stretched if it had to fork out an additional RM10.7m to buy back the tea from KSC. As at end-2QFY09, Hai-O had RM59.4m net cash in its balance sheet.

Risks

- ◆ **The risks include:** (1) Termination of supply agreements from its suppliers in China; and (2) Contraction in consumer spending in Malaysia.

Forecasts and recommendation

- ◆ **We have revised our FY09-11 forecasts downwards** by 10.4-13.0% to RM47-58m to reflect lower distributor productivity, lower retail sales per outlet growth and lower sales from wholesale division.
- ◆ **Fair value reduced, but maintain Outperform.** Indicative fair value for Hai-O has been reduced to RM4.15 (from RM4.74), based on unchanged 7x CY09 EPS, representing a 40% discount to our target PE for the consumer sector on account of its small market capitalisation. Note that Hai-O intends to maintain its net dividend payout at 50%, which translates to net yield of 6.8%. Maintain Outperform.

Table 3. Earnings Forecasts

FYE Apr (RMm)	FY08a	FY09F	FY10F	FY11F
Turnover	373.8	406.9	438.7	492.2
Turnover growth (%)	96%	9%	8%	12%
Cost of Sales	-247.7	-271.0	-286.7	-325.2
Gross Profit	126.1	135.9	152.0	167.0
EBITDA	69.4	66.1	70.9	79.0
EBITDA margin (%)	19%	16%	16%	16%
Depreciation	-2.2	-2.1	-2.1	-2.1
Net Interest	0.5	1.0	1.3	2.0
Associates	0.0	0.0	0.0	0.0
Pretax Profit	67.7	64.9	70.1	78.9
Tax	-18.7	-17.5	-18.9	-20.5
Minorities	-0.6	-0.6	-0.6	-0.7
Net Profit	48.5	46.8	50.6	57.7

Source: Company data, RHBRI estimates

Table 4. Forecast Assumptions

FYE Apr	FY09F	FY10F	FY11F
Core distributor force (CDF)	82,000	92,000	102,000
Distributor productivity (RM/CDF)	3,960	3,840	3,960
Opening of new retail outlets	2	1	0
Revenue per outlet (RM'000)	698	705	716

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Outperform = The stock return is expected to exceed the KLCI benchmark by greater than five percentage points over the next 6-12 months.

Trading Buy = Short-term positive development on the stock that could lead to a re-rating in the share price and translate into an absolute return of 15% or more over a period of three months, but fundamentals are not strong enough to warrant an Outperform call. It is generally for investors who are willing to take on higher risks.

Market Perform = The stock return is expected to be in line with the KLCI benchmark (+/- five percentage points) over the next 6-12 months.

Underperform = The stock return is expected to underperform the KLCI benchmark by more than five percentage points over the next 6-12 months.

Industry/Sector Ratings

Overweight = Industry expected to outperform the KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Neutral = Industry expected to perform in line with the KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Underweight = Industry expected to underperform the KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

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