Malaysia

MARKET DATELINE • PP 1505(7767)/09/2008(010132)

# Corporate Highlights

## Results Note

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

**27 March 2008**

# Hai-O Enterprise

*3QFY04/08 Results Boosted By MLM*

| | | |
|---|---|---|
| Share Price | : | RM3.00 |
| Fair Value | : | RM4.64 |
| Recom | : | **Outperform** (Maintained) |

**Table 1: Investment Statistics (HAIO ; Code: 7668) — Bloomberg Ticker: HAIO MK**

| FYE Apr | Revenue (RMm) | Net Profit (RMm) | EPS (sen) | EPS gwth (%) | PER (x) | C.EPS* (sen) | NTA/share (x) | Net gearing (x) | ROE (%) | Net. Div. Yld. (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| 2007a | 189.3 | 21.4 | 26.4 | 105.3 | 11.4 | | 1.5 | Net cash | 11.0 | 3.7 |
| 2008f | 319.2 | 38.1 | 45.8 | 73.8 | 6.5 | 33.0 | 1.6 | Net cash | 15.9 | 4.0 |
| 2009f | 368.5 | 38.8 | 46.7 | 1.9 | 6.4 | 38.0 | 1.9 | Net cash | 13.2 | 4.8 |
| 2010f | 409.8 | 42.6 | 51.3 | 9.9 | 5.8 | 45.0 | 2.3 | Net cash | 12.1 | 5.3 |

*Main Board Listing / Trustee Stock / Syariah-Approved Stock By The SC*
*^ Consensus based on IBES Estimates*
** Adjusted for bonus issue for light-to-light comparison*

- **Results beat our forecasts.** 9MFY04/08 net profit accounted for 98-105% of our full-year forecasts and market estimates. The variance was due to higher-than-expected distributor productivity.

- **Manufacturing contract of Stevia to start contributing in FY04/09.** This contract will provide the company a total minimum guaranteed revenue of RM30m for three years. The profit margin for producing this product could be higher than its existing manufacturing margin, ie. >30%.

- **Risks to our view.** The major risks include: 1) termination of supply agreements from its suppliers in China; and 2) slowdown in consumer spending in Malaysia. We think the termination of supply agreements is unlikely to happen. Also, we expect consumer spending to remain resilient underpinned by high consumerism of the young population in Malaysia.

- **Change in earnings projections.** We raise our FY04/08-10 net profit by 55-79% to reflect the higher distributor productivity.

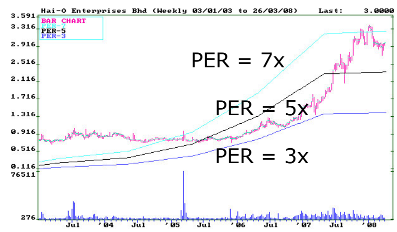
- **Investment case.** Corresponding to change in FY04-08-10 earnings projection, indicative fair value is upgraded to RM4.64 from RM4.04 based on unchanged target PE of 10x CY08 EPS, which is at a 40% discount to our CY08 target PE of 16x for the consumer sector, to reflect its smaller earnings base and market capitalisation. Maintain **Outperform.**

| RHBRI | Vs. | Consensus |
|---|---|---|
| ✓ | Above | ✓ |
| | In Line | |
| | Below | |

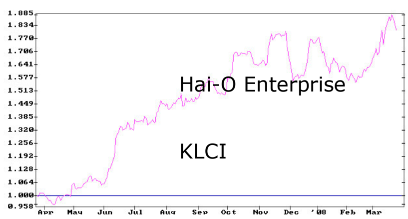
| | |
|---|---|
| Issued Capital (m shares) | 82.6 |
| Market Cap(RMm) | 247.8 |
| Daily Trading Vol (m shs) | 0.1 |
| 52wk Price Range (RM) | 1.36-3.30 |
| **Major Shareholders:** | **(%)** |
| Tan Family | 25.0 |
| Excellent Communication | 5.2 |

| FYE Apr | FY08 | FY09 | FY10 |
|---|---|---|---|
| EPS chg (%) | 79% | 56% | 55% |
| Var to Cons (%) | 39% | 23% | 14% |

**PE Band Chart**




**Relative Performance To KLCI**




**Please read important disclosures at the end of this report.**

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**9MFY04/08 Results**

- **Results beat our forecasts.** 9MFY04/08 net profit accounted for 98-105% of our full-year forecasts and market estimates. We think the variance was due to higher-than-expected distributor productivity of RM2,700/distributor for 9MFY04/08 vis-à-vis our expectation of RM2,400/distributor for FY04/08. Currently, Hai-O has a distributor force of 78,000 members which is in line with our full-year target of 84,000 members.
- **9MFY04/08 net profit surged 120% yoy.** This was mainly due to the increase in contribution from the MLM division on the back of higher distributor productivity.

**Future prospects**

- **Manufacturing contract of Stevia to start contributing in FY04/09.** The recently-signed exclusive manufacturing contract from Pure Circle to manufacture Stevia natural sweetener for the next five years is expected to begin contributing in FY04/09. This contract will provide the company a total minimum guaranteed revenue of RM30m for three years. We note that Hai-O would not incur significant capex to carry out the manufacturing activity. Also, the profit margin for producing this product could be higher than its existing manufacturing margin, ie. >30%. Based on Hai-O's entrenched position in the traditional Chinese medicine market in China, we expect Hai-O to be appointed as an exclusive distributor in China to distribute Stevia. However, we have not factored in the appointment of Hai-O as the exclusive distributor in China into our earnings forecasts.

**Risks**

- **Risks to our view.** The major risks include: 1) termination of supply agreements from its suppliers in China; and 2) slowdown in consumer spending in Malaysia.
- **Mitigating factors.** We think Hai-O and its counterparts in China have established a solid business relationship, and neither of them would want to jeopardise the relationships. As for consumer spending, we expect consumer spending to remain resilient underpinned by high consumerism of the young population in Malaysia.

**Forecasts And Assumptions**

- **FY04/08 net profit upgrade.** We raise our distributor productivity assumptions to RM1,700/distributor in FY04/08 (from RM1,400), RM2,781/distributor in FY04/09 (from RM1,442), and RM2,864/distributor (from RM1,485). As such, we raise our FY04/08-10 net profit projections by 55-79% to reflect this.
- **Earnings assumptions**. We expect the MLM division to chalk up higher growth in FY04/08-10 underpinned by: 1) an addition of 10,000-24,000 new distributors per year; and 2) an increase in distributor productivity by 3% p.a. from the estimated RM2,700/distributor in FY04/08. Moreover, the retail segment should also see higher earnings in FY04/08 on the back of maiden contributions from five new retail outlets at Sungai Long, Bandar Utama, Queensbay Mall, Subang Parade and Bukit Tinggi. We expect Hai-O to open three retail stores each in FY04/09-10.

**Valuations And Recommendation**

- **Valuation upgraded.** Corresponding to the change in our FY04/08-10 earnings projection, indicative fair value is upgraded to RM4.64 from RM4.04 based on unchanged target PE of 10x CY08 EPS, which is at a 40% discount to our CY08 target PE of 16x for the consumer sector, to reflect its smaller earnings base and market capitalisation. Maintain **Outperform.**

**Table 2. Earnings Review (YoY Cumulative)**

| FYE Apr (RMm) | 3Q07 | 2Q08 | 3Q08 | QoQ (%) | YoY (%) | 9M07 | 9M08 | YoY (%) | Comments |
|---|---|---|---|---|---|---|---|---|---|
| Revenue | 51.4 | 80.5 | 100.5 | 24.8 | 95.5 | 132.6 | 240.3 | 81.2 | Mainly due to increase in distributor productivity. |
| *- Wholesale & Retail* | *22.1* | *20.1* | *25.0* | 24.0 | 13.3 | 62.9 | 63.5 | *1.0* | |
| *- MLM* | *28.6* | *59.5* | *74.7* | 25.5 | 161.4 | 66.9 | 174.3 | *160.6* | |
| *- Other* | *0.8* | *0.8* | *0.8* | -6.3 | 2.6 | 2.8 | 2.4 | *-13.9* | |
| EBIT | 7.5 | 12.9 | 18.4 | 42.7 | 145.2 | 20.5 | 41.1 | 100.6 | MLM and wholesale generally provide higher margins than retail and manufacturing. |
| Finance cost | 0.0 | 0.1 | 0.1 | -27.5 | 1750.0 | -0.1 | 0.2 | -480.0 | |
| PBT | 7.5 | 13.0 | 18.5 | 42.2 | 146.0 | 20.4 | 41.3 | 102.2 | Filtered down from operating profit. |
| Taxation | -2.3 | -3.6 | -4.9 | 37.0 | 118.4 | -6.1 | -11.4 | 87.8 | |
| MI | -0.3 | -0.3 | -0.1 | -55.9 | -54.8 | -0.9 | -0.3 | -63.7 | |
| Net profit | 5.0 | 9.1 | 13.4 | 47.2 | 169.6 | 13.4 | 29.6 | 119.8 | |
| EPS (sen) | 7.6 | 13.6 | 18.2 | 34.0 | 139.6 | 20.5 | 42.2 | 105.6 | |
| Gross dividend | 0.0 | 8.0 | 0.0 | -100.0 | na | 5.0 | 8.0 | 60.0 | |
| | | | | | | | | | |
| EBIT margin (%) | 14.6 | 16.0 | 18.3 | 2.3 | 3.7 | 15.4 | 17.1 | 1.7 | |
| PBT margin (%) | 14.6 | 16.1 | 18.4 | 2.2 | 3.8 | 15.4 | 17.2 | 1.8 | |
| Net profit margin (%) | 9.7 | 11.3 | 13.3 | 2.0 | 3.7 | 10.1 | 12.3 | 2.2 | |
| Effective tax rate (%) | 30.2 | 27.8 | 26.8 | -1.0 | -3.4 | 29.8 | 27.6 | -2.1 | |

*Source: Company, RHBRI*

**Table 3. Earnings Forecasts**

| FYE Apr (RMm) | FY07a | FY08F | FY09F | FY10F |
|---|---|---|---|---|
| **Turnover** | **189.3** | **319.2** | **368.5** | **409.8** |
| Turnover growth (%) | 31% | 69% | 15% | 11% |
| Cost of Sales | -119.6 | -202.7 | -232.2 | -258.2 |
| Gross Profit | 69.7 | 116.5 | 136.3 | 151.6 |
| **EBITDA** | **33.2** | **56.2** | **57.4** | **63.1** |
| EBITDA margin (%) | 18% | 18% | 16% | 15% |
| Depreciation | -2.3 | -2.2 | -2.7 | -3.4 |
| Net Interest | -0.3 | 0.0 | 0.3 | 0.8 |
| Associates | 0.0 | 0.0 | 0.0 | 0.0 |
| **Pretax Profit** | **30.6** | **54.0** | **55.0** | **60.5** |
| Tax | -8.5 | -14.6 | -14.9 | -16.3 |
| Minorities | -0.7 | -1.3 | -1.4 | -1.5 |
| **Net Profit** | **21.4** | **38.1** | **38.8** | **42.6** |

*Source: Company data, RHBRI estimates*

**Table 4. Forecast Assumptions**

| FYE Apr | FY08F | FY09F | FY10F |
|---|---|---|---|
| Core distributor force (CDF) | 84,000 | 96,000 | 106,000 |
| Distributor productivity (RM/CDF) | 2700 | 2781 | 2864 |
| Opening of new retail outlets | 4 | 3 | 3 |
| Revenue per outlet (RM'000) | 691 | 705 | 719 |

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The recommendation framework for stocks and sectors are as follows : -

Stock Ratings

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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