8 October 2007

AFFIN INVESTMENT BANK

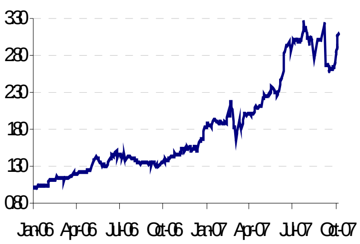
Initiate Coverage

Hai-O Ent

HAIO MK
RM3.08

BUY

Target Price: RM3.88



Price Performance

	1M	3M	12M
Absolute	15.5	23.2	163.9
Rel to KLCI	9.8	23.3	86.8

Stock Data

Issued shares (m)	82.6
Mkt cap (RMm)	254.3
Avg daily vol - 6mth (m)	0.2
52-wk range (RM)	1.13-3.08
Est free float	50%
NTA per share (RM)	1.63
P/NTA (x)	1.9
Net cash/ (debt) (RMm) (July 07)	52.6
ROE (2008F)	23.3%
Derivatives	Nil

Key Shareholders

Tan family	25.6%
Maybank Smallcap	3.9%

Earnings & Valuation Revisions

	08E	09E	10E
Prev EPS (sen)	-	-	-
Curr EPS (sen)	38.7	45.8	54.1
Chg (%)	-	-	-
Prev target price (RM)			-
Curr target price (RM)			3.88

Kevin Low
(603) 2143 2235
kevin@affinsecurities.com.my

Chong Yoke Ting
(603) 2142 1212
ytchong@affinsecurities.com.my

Direct Marketing Catapulting Growth

Initiate coverage with a BUY and target price of RM3.88 (+26% upside)
We initiate coverage on Hai-O with a BUY rating based on a RNAV derived target price of RM3.88. Hai-O offers a cheap entry into the relatively stable consumer and retail segment, which is benefiting from rising consumer sentiments and affluence. For 8.5x CY08 EPS (6.8x after stripping off cash per share of RM0.63), investors not only get a piece of an efficient nationwide wholesaler of traditional medicine and retail franchise (54 outlets nationwide), but also a lucrative stake in its rapidly expanding multi-level-marketing (MLM) business.

MLM business to fuel 3-year EPS CAGR of 20%
Holding exclusive distribution rights for over 200 types of Chinese medicines, health tonics, teas and healthcare products, Hai-O's wholesale and retail divisions generate a steady stream of earnings for the group. Its earnings profile is thus enhanced by the rapidly growing MLM business (53% of FY07 revenue), which has grown at a PBT CAGR of 76% over the past 2 years. Unlike the limited market size its Chinese products serve, its MLM business is centred on all ethnic groups. With a growing active agency force which is remunerated by a class leading reward scheme, we believe that there is a scalable and untapped market, particularly the Bumiputera ethnic group. Conservatively, our earnings forecast excludes any earnings contribution from new markets in Indonesia.

Strong and sustainable dividends ahead
With growing free cash flows of RM16-RM27m, minimal capex requirement and an ample net cash position of RM52.6m (as of 30 Sep 07), we estimate gross dividends to rise from 17 sen in FY07 to 23 sen by FY10 based on management's dividend policy of 50%. This translates to above market yields of 5.4% –7.6% over FY08-FY10.

Ripe for a re-rating
We believe that Hai-O is still grossly undervalued while the market continues to ignore its: 1) scalable MLM business; 2) strong 3-year EPS CAGR of 20% over FY07-FY10; 3) above market average dividend yields of 7.0%; 4) healthy financial position – Hai-O's cash pile of RM52.6m has been steadily growing, and supportive of its growing dividend payout; 5) Improving ROEs 23.4% for FY08; 6) Improved liquidity with the recent 1:5 bonus issue and transfer of listing status to the Main Board on 8 October 07.

Key risks lie in consumption slowdown
Key risks in our view lies in: 1) loss of agents/distributors in MLM division; 2) lack of new exciting products to enhance growth in MLM division; and 3) over-dependence on principal products

Earnings and Valuation Summary

FYE 30 April	2005	2006	2007	2008F	2009F	2010F
Revenue (RMm)	141.5	146.8	189.3	229.3	260.0	297.6
EBITDA (RMm)	13.5	17.8	32.7	39.7	45.2	52.7
Pretax profit (RMm)	10.3	15.1	30.6	37.3	43.3	50.9
Net profit (RMm)	5.5	10.2	21.4	26.8	31.7	37.3
EPS (sen)	8.0	14.8	31.0	38.8	45.9	54.1
EPS growth (%)	41.7	84.9	110.0	25.1	18.5	17.8
PER (x)	38.6	20.9	9.9	7.9	6.7	5.7
Core net profit (RMm)	5.5	10.2	21.4	26.8	31.7	37.3
Core EPS (sen)	8.0	14.8	31.0	38.8	45.9	54.1
Core PER (x)	38.6	20.9	9.9	7.9	6.7	5.7
DPS (sen)	5.0	6.7	15.0	16.6	20.0	23.3
Dividend Yield (%)	1.6	2.2	4.9	5.4	6.5	7.6
EV/EBITDA (x)	15.5	11.5	5.4	4.2	3.5	2.7
Consensus profit (RMm)			-	25.5	28.5	-
Affin/Consensus (x)			-	1.0	1.1	n.a.

Valuations and Recommendation

Too cheap to ignore, initiate with BUY and target price of ***RM3.88***

Initiating coverage with a BUY and target price of RM3.88

We initiate coverage on Hai-O with a BUY rating and RNAV based target price of RM3.38, implying a mere CY08 PER of 8.5x – or a compelling 6.8x multiple adjusting for its RM0.63 cash per share. We believe Hai-O is grossly undervalued as the market has not appreciated: 1) its strong earnings growth - 3-year projected FY07-10 EPS CAGR of 20% (3-year actual FY04-07 EPS CAGR of 77%), 2) above market FY07-10 dividend yields of 5.4-7.6% underpinned by its strong cash position, growing annual free cash flow of RM16-27m in FY07-10 given its low capex requirement (average RM2-3m per year) and 50% dividend payout policy, and 3) rising ROEs 23.4% for FY08.

Fig 1: RNAV valuation of RM3.88

Divisions	CY08 net profit	Applied PER (x)	Value RM'm	Comments
MLM	13.6	8	114.1	Target PER at a 20% discount to MLM average
Retail	1.5	9	13.6	Retail franchise PERs range from 11x-20x
Wholesale	12.6	6	81.1	Fair PER for a fairly stable business
Manufacturing	0.3	8	2.3	Regional pharmaceutical companies trade between 9x-44x
Others	1.1	4	4.3	Reasonable for its traditional Chinese clinics
Net cash/debt			52.6	
			268.1	
No of shares (m)			69.0	
RNAV/share			3.88	

Source: Affin Investment Bank

Fig 2: Peers comparison

Company		FYE	Market Cap (USD)	PER (x) CY07	PER (x) CY08	Div Yld (%) CY07	Div Yld (%) CY08	ROE (%) CY07	ROE (%) CY08	EV/EBITDA (x) CY07	EV/EBITDA (x) CY08
Retail											
Guangzhou Pharmaceutical Co Ltd	Hong Kong	Dec	881.4	23.3	18.6	1.4	1.4	8.7	10.3	12.8	11.0
Tong Ren Tang Technologies Co Ltd	Hong Kong	Dec	106.5	16.5	14.4	2.5	2.6	18.8	19.0	10.9	9.5
Eu Yan Sang International Ltd	Singapore	June	150.5	12.1	11.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Average				**17.3**	**14.7**	**1.9**	**2.0**	**13.8**	**14.7**	**11.8**	**10.2**
MLM											
Amway (Malaysia) Hldgs	Malaysia	Dec	322.5	16.4	15.3	7.2	7.3	32.9	34.7	10.3	9.7
Zhulian Corp Bhd	Malaysia	Nov	96.5	6.2	5.7	11.9	13.0	26.2	25.6	3.3	3.1
Average				**11.3**	**10.5**	**9.6**	**10.1**	**29.5**	**30.1**	**6.8**	**6.4**
Manufacturing											
Jiangsu Hengrui Medicine Co Ltd	China	Dec	2,319.0	56.1	43.9	0.7	0.8	18.9	20.8	41.4	34.7
Aurobindo Pharma Ltd	India	Mar	808.4	10.9	9.5	1.2	1.4	22.9	21.8	10.1	8.9
Cadila Healthcare Ltd	India	Mar	968.9	11.8	9.9	1.8	2.0	28.9	28.3	9.6	8.2
Cipla Ltd/India	India	Mar	3,724.9	18.9	16.3	1.7	1.9	21.3	20.4	15.6	13.9
Dishman Pharmaceuticals & Chemicals Ltd	India	Mar	534.6	15.6	12.1	0.6	0.7	28.6	31.1	12.5	9.8
GlaxoSmithKline Pharmaceuticals Ltd	India	Dec	2,317.3	22.3	19.5	2.3	2.1	32.9	29.7	16.5	14.0
Glenmark Pharmaceuticals Ltd	India	Mar	2,501.7	25.8	10.5	0.2	0.3	51.1	45.9	26.6	17.3
Matrix Laboratories Ltd	India	Mar	934.0	17.9	13.7	0.7	0.9	13.7	17.8	15.9	11.4
Aventis Pharma Ltd/India	India	Dec	678.3	13.6	11.7	2.2	2.3	27.5	26.4	8.3	7.1
Lupin Ltd	India	Mar	1,223.3	14.7	12.7	1.1	1.2	30.6	25.8	11.9	11.2
Marico Ltd	India	Mar	999.6	22.1	18.2	1.5	1.6	54.7	47.0	16.3	13.8
Pfizer Ltd/India	India	Nov	536.1	17.4	15.5	1.9	2.2	38.1	19.9	10.9	8.9
Ranbaxy Laboratories Ltd	India	Dec	4,178.4	26.4	23.6	2.0	2.3	22.9	22.2	19.4	17.3
GlaxoSmithKline Consumer Healthcare Ltd	India	Dec	668.3	17.2	15.1	2.2	2.5	24.9	24.4	11.3	10.0
Sun Pharmaceutical Industries Ltd	India	Mar	4,643.1	18.2	17.3	1.0	1.3	28.9	26.6	19.5	15.9
Wockhardt Ltd	India	Dec	1,153.4	14.9	12.2	1.5	1.7	28.0	27.7	10.3	8.6
CCM Duopharma Biotech Bhd	Malaysia	Dec	113.8	9.2	7.6	7.7	7.7	18.7	20.0	6.4	5.3
Pharmaniaga Bhd	Malaysia	Dec	111.1	15.3	14.7	4.3	4.3	7.0	7.1	7.3	6.6
Average				**19.4**	**15.8**	**1.9**	**2.1**	**27.7**	**25.7**	**15.0**	**12.4**
Wholesale											
Yunnan Baiyao Group Co Ltd	China	Dec	2,197.9	50.5	39.8	0.6	0.7	29.1	27.4	35.7	31.0
China National Medicines Corp Ltd	China	Feb	825.1	51.3	40.5	1.1	1.2	17.7	18.4	49.1	45.6
Huadong Medicine Co Ltd	China	Mar	832.3	58.3	47.1	1.4	1.4	14.2	15.5	30.9	26.6
Average				**53.4**	**42.5**	**1.0**	**1.1**	**20.3**	**20.4**	**38.6**	**34.4**

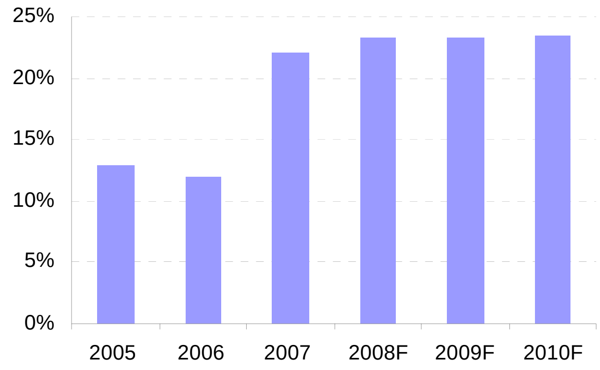
Source: Bloomberg, Affin Investment Bank

Transfer of listing to the Main Board of Bursa on 8 October

Main Board listing to aid liquidity

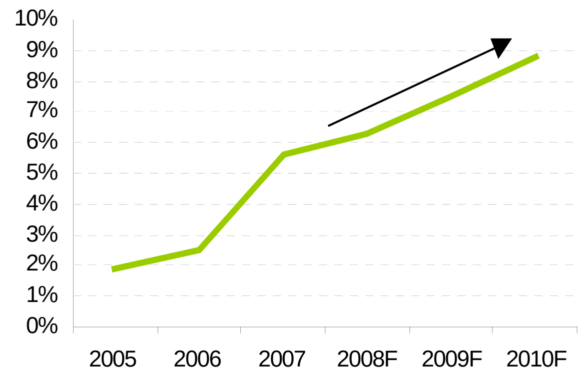
Hai-O transfers its listing to the Main Board of Bursa, with effect from 8 October 2007. The elevation of its listing status, and enlarged share base in view of the recent exercise of 1:5 bonus issue (raising outstanding shares to 83m from 69m), would enhance its profile and stock liquidity.

Fig 3: ROEs strong and rising



Source: Company data, Affin Investment Bank estimate

Fig 4: Dividend yields above market



Source: Company data, Affin Investment Bank estimate

Intensive share buyback continues

Intensive share buyback for past few months

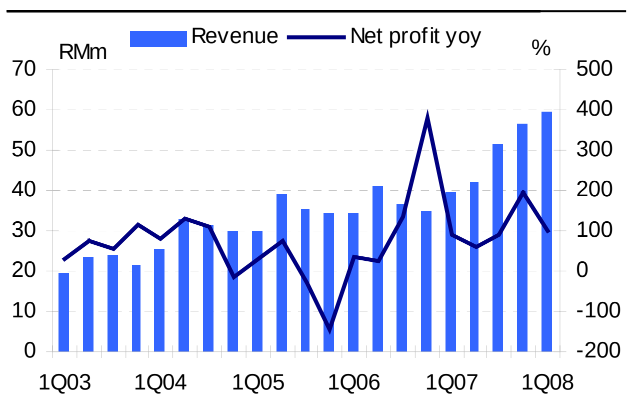
Over the past 6 months, the company has bought back 835,000 shares and its cumulative Treasury shares presently stands at 2.3m shares (2.8% of issued shares based of 83m) worth RM7.1m. This is made possible by its strong balance sheet and surplus free cash flow. In addition, this also reflects management's belief that the stock remains under valued.

Qoq revenue and earnings have been on the improving trend

Improving sequential earnings

Hai-O's historical quarterly revenue and earnings have been on the rising trend since 1Q05. We expect strong sequential earnings momentum in the quarters ahead, projecting FY08 revenue and net profit growth of +21.1% and +25.1% respectively, led by the MLM division and augmented by the consistent income from wholesale and retail divisions.

Fig 5: Sequential improvement in earnings



Source: Company data, Affin Investment Bank estimate

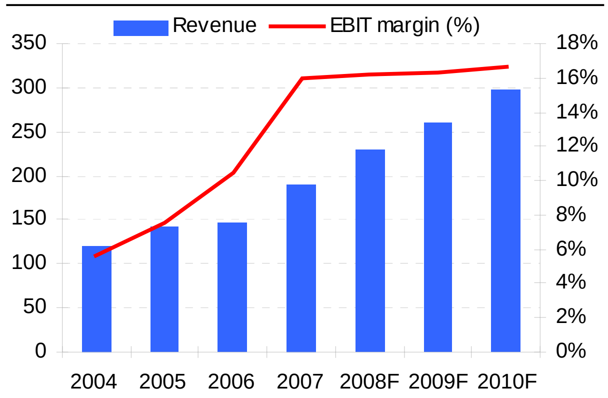
Earnings Outlook

Better margins ahead

Weak margins a thing of the past

Hai-O suffered from weak margins in the past (EBIT margin of 5.6% in FY04 compared to 16.0% in FY07) due to a combination of: 1) unprofitable non-core units being a drag to group earnings; and 2) smaller contribution from its MLM business, which was also undergoing a revamp.

Fig 6: Margins steadily improving



Source: Company data, Affin Investment Bank estimate

3-year historical EPS CAGR of 77%

Reaping the benefits from its restructuring

This has however changed for the better in late 2005 and early 2006, when Hai-O undertook a restructuring - disposing its non-core assets and non-performing businesses including the termination of Plaza UE3 mall management, supermarket operations (Pasaraya D'Choice), Beijing Hope Computer and Golden Chopstick Restaurant.

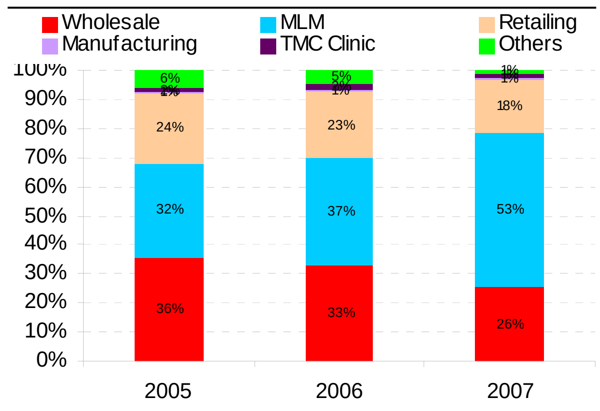
Additionally, the past efforts taken to revamp its MLM business have also kicked-in. Earnings contributions from its MLM business began to surge, rising from RM2.2m in FY05 to RM10m in FY07. Taken together, overall earnings grew from RM3.9m in FY04 to RM21m in FY07, representing a strong EPS CAGR of 77% over FY04-07.

20% EPS CAGR over FY07-FY10

MLM to fuel group earnings growth

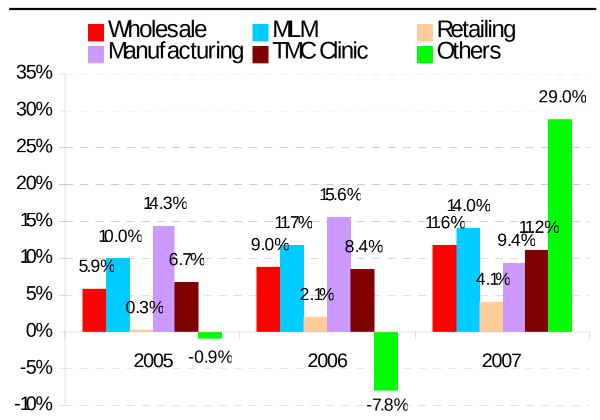
We project a strong 3-year EPS CAGR of 20% which driven largely by 1) higher contribution from its MLM division (accounts for 53% of sales), underpinned by rising sales of big ticket items from its healthcare range (comprising beauty products and water filters - both accounting for nearly 88% of MLM turnover in FY07) that carry high margins; 2) growing contribution from its tea products, which command a rising margins; 3) improved product mix in favour of better margin house brands and 4) positive impact on strengthened ringgit as Hai-O's imports account for 60%-70% of group purchases. We estimate that every 1% appreciation of the ringgit; will lift gross margins by +0.3%.

Fig 7: MLM division accounts for > 53% of sales



Source: Company data, Affin Investment Bank estimate

Fig 8: Firmer PBT margin across major divisions



Source: Company data, Affin Investment Bank estimate

3-prong earnings growth drivers

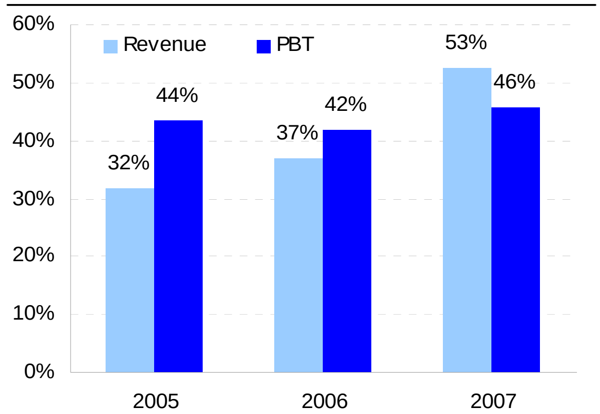
A. Multi Level Marketing Division

Robust growth from MLM division

Revenue from MLM division has doubled in 2 years and now contribute 53% of group turnover

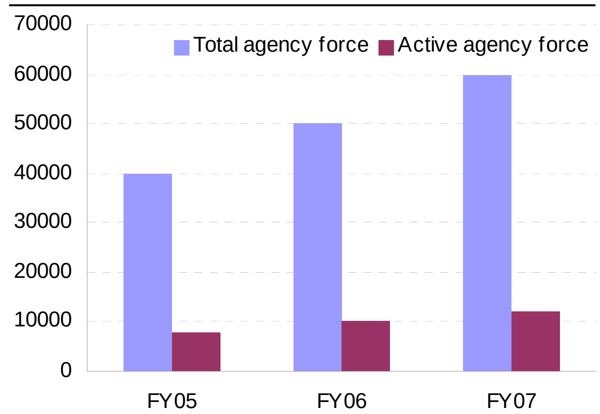
The multi-level-marketing (MLM) business for Hai-O is gaining significance and accounted for nearly 53% and 46% of revenue and PBT for the group in FY07. This was also the most robust division within the group over the past 3-years, with revenue more than doubling to RM99.7m in FY07 (RM45.1m in FY05). In tandem with the strong revenue growth, PBT margin has also improved to 14% in FY07 from 10% in FY05. The strong growth was spearheaded by: 1) acceleration in agency headcount - Hai-O had 60k agents in FY07 (40k in FY05 or more than double the number from 2001), where about 20% of the total agents are active agents. The number of agents are growing at a rate of 1000 a month and; 2) increasing sales of higher-valued products – its inner beauty wear and water filters (average prices of RM1,000-RM3,000) account for roughly 60% and 28% each respectively of MLM turnover.

Fig 9: Growing contribution from MLM business



Source: Company data, Affin Investment Bank estimate

Fig 10 Agency force steadily rising



Source: Company data, Affin Investment Bank estimate

Attractive commission scheme boosts agency base

Commission scheme deemed the best among MLM companies

We attribute the strengthened agency force to its very generous commission scheme of 65% as compared to market average of 40-60%, which is also deemed the most attractive amongst MLM companies in the country. With a strong payout and continuous focus on training and development, we believe that Hai-O will not only be able to retain but also continue to grow its agency force.

Targeting the bumiputera segment

Bumiputera segment fuels growth

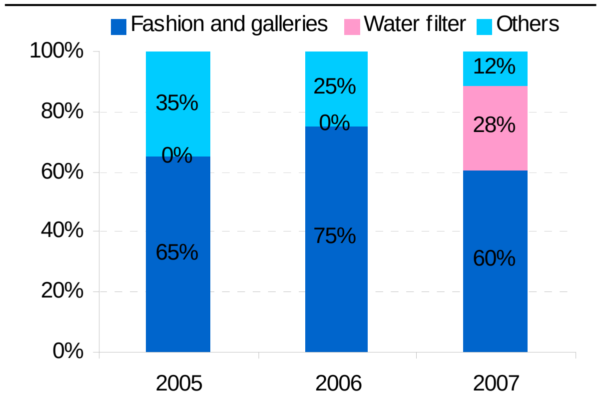
Nearly 95% of Hai-O's agency force comprises of the Bumiputera ethnic group (mainly women), which predominantly targets the Bumiputera population segment. Targeting the Bumiputera population has been the key growth driver for the MLM division over the last 4-5 years. This is largely attributed to: 1) its consumables (even the traditional medicines) being Halal certified and 2) easy funding – bumiputeras/civil servants being eligible for consumer loan financing from a cooperative bank, known as Bank Rakyat for the purchase of its higher valued products. Consequently, Hai-O does away with bearing the cost of easy financing schemes while all purchases are on cash terms. In addition, with the civil servants pay hike effective July 2007, these will eventually enhance the MLM business.

New products drive growth

As well as with the introduction of new products…air purifiers next

Sale of water purifiers under the high-end Bio Aura range (purifying water while maintaining minerals) contributed maiden revenue of RM28m in FY07. Management remains upbeat on the prospects of these water purifiers this year, similar to the strong demand it is experiencing for its inner beauty wear which has seen revenue double over a period of 2 years. Consequently, management has guided for 1-2 new products to be introduced per annum in order to spur growth for the MLM division. The introduction of air purifiers for households, would be a near term catalyst.

Fig 11: Two products contribute significant to MLM business



Source: Company data, Affin Investment Bank

Although the MLM division has a huge array of consumable and non-consumable products (>8,000 items), it is highly common that a few key products account for bulk of revenue. This is evident in Amway (Nutralite (nutrition & wellness supplements) and Artistry (skincare & cosmetics)), CNI (ginseng coffee), Zhulian (jewellery and nutritional) and Liqua Health.

Fig 12: Comparison of key product in local MLM companies

Amway	CNI	Zhulian	Liqua Health
Nutralite and Artistry – contribute more than 60% of revenue	Coffee-based beverages - Ginseng coffee, etc. – contribute more than 70% of revenue	Jewellery and nutritional – contribute more than 55% of revenue	Liqua health and Liqua Spirulina – contribute more than 90% of revenue

Source: Company data, Affin Investment Bank

Scalable Indonesian expansion

Indonesian expansion can provide significant upside in FY09

A key expansion plan for Hai-O entails replicating its successful MLM business model in Indonesia. Preliminary work has already been undertaken and a local partner identified. However, relevant approvals required for food and medicine from Indonesian authorities is currently been sought, which we understand is likely to be secured by early 2008. While it is still too early to provide an indication of earnings potential, we note that the market potential is nearly 10x that of Malaysia, and furthermore both share similar demographics and taste. Conservatively, we have assumed zero contribution from Indonesia into our forecast.

Hai-O appears to be attractive compare to others MLM

Hai-O has carved out a niche market for itself and thus has attracted lots of agents/distributors. Table below show the different business model between Amway and Hai-O.

Fig 13: Comparison between Hai-O and Amway

AMWAY	HAI-O
- Market capitalisation more than 10x the size of Hai-O	- Market capitalisation is small and niche
- Marketing Plan o Commission payout (max 40% of Amway product cost) to agents/distributors in Malaysia	- Marketing Plan o Higher commission payout (max 65% of Hai-O product cost) to agents/distributors in Malaysia o Highest commission among the MLM competitors in Malaysia
- Well established brandname and matured business	- At infant and developing stage
- Agents – focuses on multi race	- Agents – Successful in penetrating the largest and fastest growing population group with over 95% are Bumiputera. Management finds that Bumiputera agents are loyal to the company. In addition Hai-O's marketing structure is suitable to the Bumiputera market (e.g. provides training classes, support, etc.) - Target market – 80% Malays and 20% Chinese, Indian and others. Bumiputera can borrow from govt. loan (e.g. Bank Rakyat with special rate) to buy their product needs and building its own entrepreneurship.
- Only focus on MLM business model	- Diversified business model – MLM, retail, wholesale, pharmaceutical manufacturing and TCM. This should reduce the business risk.
- Warehousing systems o Big warehouses in Central region, Southern region, Northern region and East region. o Incurred warehouse maintenance cost o Sell to distributors	- Stockist system o Around 60 stockists and sales points throughout Malaysia o Paid deposit to become a stockist and signed a consignment with Hai-O to supply goods to them o Cost borne by the stockist (e.g. training, maintenance, etc.)
• 3-year historical EPS CAGR of 24% and currently trading at PE 16x	• 3-year historical EPS CAGR of 77% and currently trading at PE 10x

Source: Company data, Affin Investment Bank

B. Wholesale Division

Steady stream of earnings from wholesale division

Wholesale division earnings growth led largely by its MLM and retail division as well as external sales

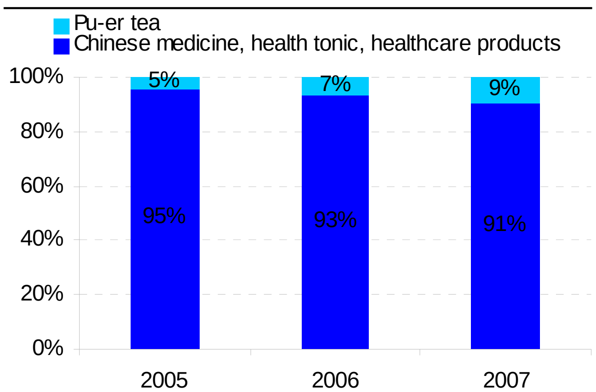
Under its wholesale division, Hai-O (which owns exclusive distribution rights for over 200 types of Chinese medicines, health tonics, teas and healthcare products) acts as a wholesaler, importing and then distributing to over 100 wholesalers and 3,000 retailers nationwide including that of Chinese Medical Halls, restaurants and modern trade channels. The wholesale division provides a steady and fairly consistent stream of earnings for the group, with growth led largely by new products and demand by its MLM and retail division.

Contribution from Pu-er tea still small, but margin enhancing

Stronger margin contribution due to increasing investment values of Pu-er tea

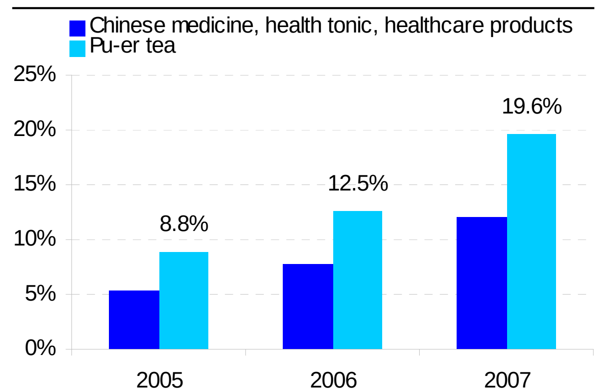
Hai-O sits on a huge stock of Pu-er tea in its wholesale division, which continues to appreciate in value over time. Similar to wine, vintage Pu-er gains both flavour and value and therefore has a ready market globally. Furthermore, the Malaysian climate and humidity levels are also believed to enhance the aging process of Pu-er tea, which explains management's growing interest in Pu-er tea. Based on group inventory levels of RM33.9m in FY07, nearly a third of this was inventory of Pu-er, with age from 6-20 years. This is also nearly 4 times the value it held in FY05. In our view, the increasing contribution of Pu-er tea is positive as it is margin enhancing. PBT margin for Pu-er tea is substantially higher at 20% in FY07 (9% in FY05) compared to 12% in FY07 (6% in FY05) its other products such as Chinese medicine, health tonic, and healthcare products. Nonetheless, the latter accounts for 91% of total revenue. We believe Pu-er tea will be a key growth driver for the wholesale division, once more Chinese restaurants and individuals recognize the potential appreciation in value of the tea and its health benefits (i.e. purported to aid digestion, reduce blood cholesterol and lipid levels)

Fig 14: Contribution from Pu-er tea still small in Wholesale



Source: Company data, Affin Investment Bank estimate

Fig 15 But Pu-er tea PBT margin enhance



Source: Company data, Affin Investment Bank estimate

C. Retail Division

Retail outlets located at high traffic shopping malls

Open 2-3 new outlets per year

Hai-O distributes its herbs and healthcare products via a chain of 54 outlets throughout Malaysia. A recent shift in strategy in which it has repositioned its outlets at high traffic shopping malls as opposed to standalone shops previously, have helped improved sales. In addition, over the last 3 years, Hai-O has closed 6 non-profitable franchise outlets and improved its house product mix, which boosted its retail PBT margins to 4.1% in FY07 from 0.3% in FY05.

Its more popular outlets include that in 1 Utama, Mega Mall and Queensbay Mall in Penang. Moving forward, management plans to open 2-3 new outlets per year, at strategic locations especially in Klang Valley.

Fig 16: Growing retail outlets

	2005	2006	2007
Total retail outlet	56	54	54
Owned	38	38	42
Franchise	18	16	12
Avg. revenue per outlet (RM 'm)	0.62	0.62	0.65
(%) yoy growth	--	0.5	4.3

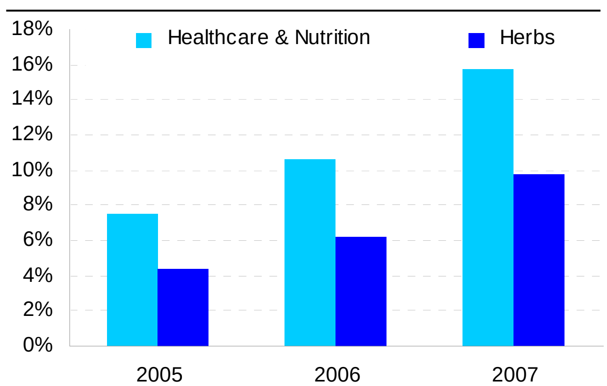
Source: Company data, Affin Investment Bank estimate

Improving product mix in favour of better margin house brands

Own brands have also pushed up margins

Hai-O's strategy to expand its house brands in retail division has also paid off handsomely, as margins are better off compared to that of pure distribution. Management continues to introduce at least 20 new products a year, which are distributed by its wholesale and pharmaceutical division. As a result, PBT margins for these products have generally doubled over a period of 2 years.

Fig 17: Improving PBT margins for its Chinese traditional medications



Source: Company data, Affin Investment Bank

Risks

Key earnings risk lies in MLM division

Loss of agents in MLM business, a key risk

Key earnings risk lies in a loss of agents for its MLM business as this would mean a disruption to our projected revenue CAGR of 16% over FY07-10.

We provide a sensitivity analysis below, indicating the potential impact on earnings given a loss in agents. Holding our average revenue per agents constant while factoring in a decrease in the number of agents, we expect a -4% to -10% decline in EPS for Hai-O for a -2% to -6% loss of agents. Hence, we believe its diversified business model, which also focuses on its retail, wholesale, pharmaceutical manufacturing and TCM, would help reduce business risk.

Fig 18: Loss of agent's analysis – Impact on earnings for Hai-O's

	Hai-O's EPS						
	% chg in agents	Existing 2008E	Adjust 2008E	% chg	Existing 2009E	Adjust 2009E	% chg
Agents	-2%	32.2	30.6	-5%	38.2	36.6	-4%
	-4%	32.2	30.0	-7%	38.2	35.2	-8%
	-6%	32.2	29.3	-9%	38.2	34.3	-10%

Source: Affin Investment Bank estimate

Slowdown in consumer spending

Slowdown on consumer spending

Similar to other retail businesses, any slowdown in domestic consumption spending would have a direct adverse impact on demand.

Over-dependence on principal products in MLM division

Over-dependence on principal products

A significant portion of Hai-O's revenue is generated from a few principal products most notably, its inner beauty wear and water filters which generated more than 50% of group revenue in FY07. These could be severely affected by any future changes in consumer preference and demand. Likewise the lack of either saleable and new products could also put a dent to the slowing growth rates projected.

Low stock liquidity

Illiquidity of its shares

With 6-month average daily trading value of only RM519k, the Hai-O's shares are quite illiquid, and could be a major deterrent for investors who wish to take up a meaningful equity interest. Nonetheless, the recent bonus issue exercise of 1:5 and its listing on the Main Board of Bursa on 8 October should improve stock liquidity. More importantly, we believe Hai-O has sufficient distributable reserves to potentially propose a further round of bonus issue given its high level of retained earnings coupled with its continue strong earnings stream. This will further improve stock liquidity and draw increased investors participation.

Appendix 1: Company background

Company profile

Hai-O Enterprise commenced operations in 1975 and was listed on the Second Board of Bursa in 1996 as the only traditional healthcare company then. Hai-O was founded by Tan Kai Hee, a well-respected figure in the Chinese community who started his corporate life late after being remanded for 8 years for his socialist beliefs. Today's, Tan still sits on the board and plays an active role in managing the company's day-to-day operations.

Hai-O is principally involved in wholesale (to over 100 large wholesalers) and retailing (2000 retail customers and 54 outlets) of traditional Chinese medicines, MLM, manufacturing of pharmaceuticals and modern Traditional Chinese Medicine clinics (TCM). Hai-O is also the first Chinese healthcare company in Malaysia to achieve Good Manufacturing Practice (GMP) standards for the manufacture of food supplements and traditional pharmaceutical products.

More focussed after recent divestment of non-core assets

Over 2005/06, Hai-O went through an internal restructuring, disposing its non-core assets and non-performing business including the termination of Plaza UE3 leasing contract, supermarket operations (Pasaraya D'Choice), Beijing Hope Computer and Golden Chopstick Restaurant. This had streamlined Hai-O business operations into five key divisions – MLM, wholesale, retail, manufacturing/pharmaceutical and TCM.

Manufacturing & pharmaceuticals

Hai-O is a pioneer in the manufacture of traditional pharmaceutical products in Malaysia. Its traditional medicine and food supplements are ISO 9001 certified and US Food and Drugs Administration (FDA) registered and manufactured both for in-house as well as for OEM customers. Given that its products have the Halal certification, some are exported to the Middle East market.

JV with China partners on modern Traditional Chinese Medicine (TCM)

Hai-O is in a JV with two Chinese TCM clinic services companies namely Tong Ren Tang (listed in Hong Kong and Shanghai) and Sanjiu Enterprise Group (listed in Hong Kong and Shenzhen) via JVs (49% and 50% respectively) to provide Chinese herbal medicines, acupuncture and massage (often known as "Qigong") treatment. Despite minimal revenue contribution from this division (1.4% in FY07), the JVs were established mainly to widen Hai-O's reach to end users while creating greater brand and TCM recognition.

Penetrating the China market

Recently, Hai-O indicated that it would tap the China and Hong Kong markets, where it intends to export its own local brand products such as Tongkat Ali Coffee and bird's nest. In addition, Hai-O also plans to introduce a vitamin supplement known as "Tri-E" (a form of vitamin E capsule) for which it has been granted exclusive sales and distribution rights by Golden Hope Plantations Bhd unit, Golden Hope Bioganic Sdn Bhd, the registered user for the product in Malaysia. Management is unable to provide any guidance to earnings although we believe that near term contribution would only be marginal. Management has also assured that it would involve only a minimal capital outlays and operating costs due to the ability to tap into its existing suppliers' distribution channels.

Fig 19: SWOT analysis

Strengths	Weakness
Strong MLM marketing structure that suited the Bumiputera market	Lack of new exciting products to kick-start growth of MLM division
Dedicated and loyal Bumiputera agents	Negative side effect of traditional medication, healthcare products, etc.
Ability to introduce new products per year	
Own pharmaceutical manufacturing capacity	
Margin enhancement as its beauty products, water filters, Pu-er tea command high margin and high revenue growth	
Products available at 54 outlets, MLM and wholesale across Malaysia	
Products are competitive in terms of pricing and quality are well accepted	
Strong foothold in China to outsource new products directly (e.g. traditional medicine, teas, herbal, etc.)	
An altruistic socialist trait that motivated its MLM members to sell harder and recruit more members	
Over 32 years of experience in traditional medicine industry	

Opportunities	Threats
Expansion into new overseas markets -	New competitors entering the market
New innovative products to enhance group earnings	Product loses among consumers
Setting up of 2-3 new retail stores to widen Hai-O's market share	Economic downturn and negative consumer sentiments
	Weaker ringgit may impact earnings as Hai-O imported products account for 60-70% of its total group purchases

Source: Affin Investment Bank

Hai-O Enterprise - Financial Summary

Profit & Loss Statement

FYE 30 April (RMm)	2006	*2007	2008E	2009E	2010E
Revenue	146.8	189.3	229.3	260.0	297.6
Operating expenses	-129.0	-156.6	-189.5	-214.7	-244.9
EBITDA	17.8	32.7	39.7	45.2	52.7
Depreciation	-2.2	-2.2	-2.3	-2.5	-2.7
EBIT	15.3	30.2	37.2	42.5	49.9
Net int income/(expense)	-0.3	0.1	0.2	0.7	1.0
Associates' contribution	-0.1	0.0	0.0	0.0	0.0
Pretax profit	15.1	30.6	37.3	43.3	50.9
Tax	-4.3	-8.5	-9.7	-10.8	-12.7
Minority interest	-0.6	-0.7	-0.9	-0.7	-0.9
Net profit	10.2	21.4	26.8	31.7	37.3

Balance Sheet Statement

FYE 30 April (RMm)	2006	*2007	2008E	2009E	2010E
Fixed assets	45.0	21.8	23.4	23.4	23.2
Other long term assets	9.6	31.8	31.8	31.8	31.7
Total non-current assets	**54.6**	**53.5**	**55.2**	**55.2**	**55.0**
Cash and equivalents	4.2	24.7	34.1	42.6	59.2
Stocks	28.1	33.9	41.7	52.0	59.5
Debtors	21.4	15.0	20.8	24.8	30.1
Other current assets	16.8	18.6	18.6	18.6	18.6
Total current assets	**70.6**	**92.3**	**115.3**	**138.0**	**167.4**
Creditors	22.7	21.6	27.0	27.9	31.2
Short term borrowings	4.4	7.4	7.8	7.4	7.4
Other current liabilities	4.0	7.3	6.7	6.9	7.3
Total current liabilities	**31.2**	**36.3**	**41.6**	**42.2**	**45.9**
Long term borrowings	0.0	0.0	0.0	0.0	0.0
Other long term liabilities	0.0	0.1	0.1	0.1	0.1
Total long term liabilities	**-**	**0.1**	**0.1**	**0.1**	**0.1**
Shareholders' Funds	**89.4**	**104.9**	**124.7**	**146.8**	**172.6**
Minority interest	**4.6**	**4.5**	**4.2**	**4.1**	**3.8**

**Changes in accounting policies to FRS 134*

Cash Flow Statement

FYE 30 April (RMm)	2006	*2007	2008E	2009E	2010E
EBIT	15.3	30.2	37.2	42.5	49.9
Depreciation & amortisation	2.5	2.5	2.6	2.7	2.8
Working capital changes	-9.9	1.0	-8.8	-13.2	-9.1
Cash tax paid	-4.3	-8.5	-9.7	-10.8	-12.7
Others	7.6	-14.0	-1.4	-1.0	-1.3
Cashflow from operation	**11.2**	**11.2**	**19.8**	**20.1**	**29.6**
Capex	-1.8	-2.0	-4.0	-2.5	-2.5
Others	-9.9	0.0	0.0	0.0	0.0
Cash flow from investing	**-11.7**	**-2.0**	**-4.0**	**-2.5**	**-2.5**
Debt raised/(repaid)	-1.0	3.0	0.4	-0.4	0.0
Dividends paid	-2.7	-3.2	-7.5	-10.0	-12.1
Others	-2.8	2.6	0.7	1.2	1.5
Cash flow from financing	**-6.5**	**2.4**	**-6.4**	**-9.2**	**-10.6**
Free Cash Flow	**9.3**	**9.2**	**15.8**	**17.6**	**27.1**

Key Financial Ratios and Margins

FYE 30 April (RMm)	2006	*2007	2008E	2009E	2010E
Growth					
Revenue (%)	3.7	29.0	21.1	13.4	14.5
EBITDA (%)	32.5	83.4	21.4	13.9	16.6
Core net profit (%)	84.9	110.0	25.1	18.5	17.8
Profitability					
EBITDA margin (%)	12.1	17.3	17.3	17.4	17.7
PBT margin (%)	10.3	16.2	16.3	16.6	17.1
Net profit margin (%)	6.9	11.3	11.7	12.2	12.5
Effective tax rate (%)	28.8	27.7	26.0	25.0	25.0
ROA (%)	8.8	18.8	19.3	19.6	19.6
Core ROE (%)	11.9	22.0	23.3	23.3	23.4
ROCE (%)	16.9	29.3	30.4	29.7	29.9
Dividend payout ratio (%)	45.1	58.1	51.6	52.3	51.8
Liquidity					
Current ratio (x)	2.3	2.5	2.8	3.3	3.6
Op. cash flow (RMm)	11.2	11.2	19.8	20.1	29.6
Free cashflow (RMm)	9.3	9.2	15.8	17.6	27.1
FCF/share (sen)	13.5	13.4	22.9	25.6	39.3
Asset management					
Debtors turnover (days)	45.3	34.6	36.3	38.5	36.9
Stock turnover (days)	75.4	72.2	72.7	79.6	83.1
Creditors turnover (days)	62.8	51.6	46.8	46.6	44.0
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)	1Q07	2Q07	3Q07	4Q07	1Q08
Revenue	39.36	41.87	51.40	56.72	59.28
Operating expenses	-33.58	-34.68	-43.90	-46.67	-49.47
EBITDA	5.78	7.19	7.50	10.05	9.81
Depreciation	0.00	0.00	0.00	0.00	0.00
EBIT	5.78	7.19	7.50	10.05	9.81
Net int income/(expense)	-0.02	-0.04	0.00	0.14	0.03
Associates' contribution	0.00	0.00	0.00	0.00	0.00
Exceptional Items	0.00	0.00	0.00	0.00	0.00
Pretax profit	5.76	7.15	7.50	10.19	9.84
Tax	-1.80	-2.01	-2.27	-2.42	-2.86
Minority interest	-0.43	-0.20	-0.27	0.00	-0.08
Net profit	3.54	4.94	4.97	7.77	7.06
Core net profit	3.54	4.94	4.97	7.77	7.06
Margins (%)					
EBITDA	14.7	17.2	14.6	17.7	16.5
PBT	14.6	17.1	14.6	18.0	16.6
Net profit	9.0	11.8	9.7	13.7	11.9

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

Affin Investment Bank Bhd (9999-V)
(Formerly known as Affin Merchant Bank Bhd)
A Participating Organisation of Bursa Malaysia Securities Bhd
(Stockbroking Division)

www.affinsecurities.com.my
Email : research@affinsecurities.com.my
Tel : 603-2143 8668
Fax : 603-2145 3005