Malaysia

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

Corporate Highlights

New Coverage

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

20 September 2007

Share Price	:	RM2.62
Fair Value	:	RM3.13
Recom	:	**Outperform**
		(Initiate coverage)

Hai-O Enterprise

More Than Just Traditional Chinese Medicine

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- We are initiating coverage on Hai-O Enterprise (Haio) with an **Outperform** recommendation. Haio is an established household name principally involved in wholesale and retail of traditional chinese medicine (TCM) as well as multi-level marketing (MLM).

- **Key Investment Points**

1. A highly complementary business model with the wholesale and retail divisions generating consistent income while the MLM division provides earnings growth;

2. A solid long-term business relationship with its Chinese suppliers has created a substantial barrier to entry and would continue to ensure a "win-win" situation for both parties; and

3. Commendable growth in MLM distributor force and distributor productivity.

- Indicative fair value is RM3.13 based on 10x CY08 EPS, which is at 40% discount to our target PER of 16x for the consumer sector. Haio is also an attractive dividend play based on our projected net dividend yield of 4.4% for FY04/08.

Table 1: Investment Statistics (Padini ; Code: 7052) **Bloomberg Ticker: PAD 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	9.9	-	1.5	Net cash	11.0	4.2*
2008f	204.6	23.7	28.6	8.4	9.2	35.0	1.4	Net cash	10.5	4.4
2009f	234.1	26.8	32.3	13.1	8.1	39.0	1.6	Net cash	10.5	5.1
2010f	262.7	30.0	36.2	11.8	7.2	-	1.8	Net cash	10.4	5.7

Issued Capital (m shares)	83.0	**Major shareholders**	**(%)**
Market Capitalisation (RMm)	217.5	Tan Family	25.0
Daily Trading Volume (m shares)	0.1	Excellent Communication	5.2
52-week Price Range (RM / s)	1.09-2.70		

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

Industry Overview

- **Core business.** Haio's core business can be segregated into wholesale, retail and multi-level marketing (MLM). Specifically, it can be divided into wholesale and retailing of Traditional Chinese Medicine (TCM) such as medicated wine (mostly made of Chinese herbs), tea (with the famous one being the "Pu-er"), health tonics and other healthcare products. Meanwhile, Haio's MLM products can be categorised into beauty & wellness, food nutrition, household and car care and accessories, and water treatment systems.

- **Rising health awareness.** The wholesale and retail TCM market is highly fragmented in Malaysia, dominated by 2 large players namely, Haio and Eu Yan Sang, and about 3,000 smaller players like traditional medical halls. According to the management, the size of the TCM market is estimated at about RM2bn per annum currently and is growing steadily. This is mainly attributable to increasing health awareness and rising affluence. *The World Health Report 2006* published by World Health Organisation observes that Malaysia's healthcare expenditure as a percentage of GDP has been on an uptrend between 1999 and 2003, increasing from 3.2% to 3.8% over the 5-year period (see Chart 1). However, this is considered low as compared with 8-15% in developed countries (see Chart 2). Moreover, the Government is expected to increase healthcare operating expenditure by 10-12% to RM9.5-10.7bn in 2007 and 2008. For this reason, we believe there is still plenty of room for sales of TCM products to grow going forward.

Chart 1: Malaysia's Increasing Healthcare Expenditure As A Percentage Of GDP

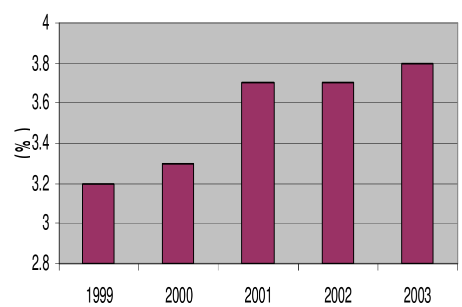
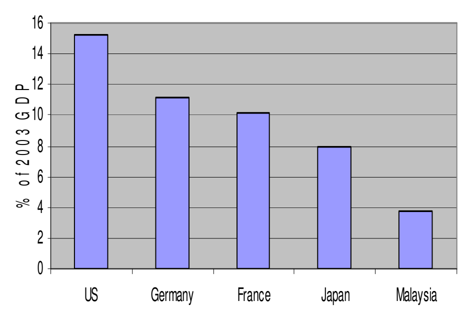


Chart 2: Malaysia's Relative Low Healthcare Expenditure As A Percentage Of FDP



Source: World Health Report 2006

- **Competitive landscape for MLM operators.** The MLM market is highly competitive and has been dominated by Amway over the last few years with its sizeable number of core distributors that outnumbers its peers. However, each player in this market has somehow carved a niche target market for itself to avoid direct competition. Having said that, launches of new products and product quality have become the crucial elements in drawing in new members into the distributor force as well as retaining the existing distributor force.

- **Background.** Established in 1975, Haio is an established household name in the Chinese community for its TCM products. Also, Haio is well known among the Malay community for its MLM products as 90% of Haio's distributors are Malay ethnic. Currently, Haio supplies TCM and MLM products to its 56 owned-retail outlets, 3,000 retail medical halls and over 60,000 MLM distributors respectively.

Key investment points.

1. A highly complementary business model with the wholesale and retail divisions generating consistent income while the MLM division provides earnings growth;

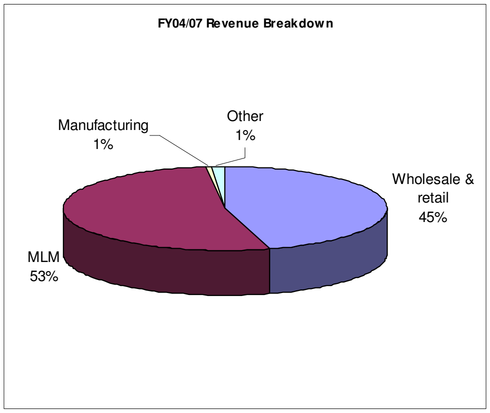
2. A solid long-term business relationship with its Chinese suppliers has created a substantial barrier to entry and would continue to ensure a "win-win" situation for both parties; and

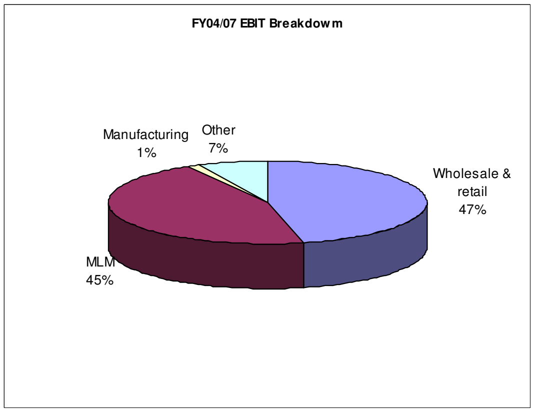
3. Commendable growth in MLM distributor force and distributor productivity.

- **Highly complementary business model.** We view Haio's wholesale and retail divisions and the MLM division highly complementary in which the former would generate consistent income while the latter would provide earnings growth. Moreover, the cash-generating retail division could provide short-term funds to meet the group's yearly operating expenses. Underpinning this, Haio's business model is highly expandable through financial leverage to enhance the group's future ROE.

- **Haio is also expanding overseas to drive future growth.** In April 2007, Haio entered into an MOU with Golden Hope **(Outperform, FV = RM10.58)** to register and distribute Golden Hope's Tri E (a form of vitamin E capsule) in China. The earnings potential is un-assessable at this stage but we are reasonably assured that it would involve only minimal capital outlays and operating costs as it could tap into its existing suppliers' distribution channels. We have not factored in contribution from Tri E as the product is still pending the necessary approval from the Ministry of Health in China. In FY04/07, the wholesale and retail and MLM divisions contribute almost equally to the group's turnover as well as EBIT (see Chart 3).

Chart 3: FY04/07 Revenue And EBIT Breakdown





Source: Haio & RHBRI

TCM Wholesale and Retail

- **The backbone of Haio.** The wholesale and the retail segments are the backbone of Haio. These segments have been registering stable revenue growth at a 3-year revenue CAGR of 3% (Separately, the wholesale and retail segments were growing at CAGR of 1% and 6% respectively, during the same period). The operating margin for these segments has also risen to 14.1% in FY04/07 from 5.6% FY04/04 mainly due to higher contributions from Pu-er tea, which yield higher margins. Going forward, we expect revenue for these segments to grow at 6% pa in FY04/08-09, coming from the opening of 4 new retail outlets each in FY04/08-09 and rising demand for Pu-er tea. We also expect margin to improve to 15% to account for higher contribution from Pu-er tea.

- **Strategic tie-up with China suppliers…** In our view, Haio's core competence in the TCM segment is derived from its size and market leader position. Haio has been granted exclusive distribution rights from its suppliers in China to market over 200 brands of renown Chinese medicines, health tonics, tea and healthcare products in Malaysia (Appendix A). This, to a great extent, can be attributed to the group's founder, Mr. Tan Kai Hee, who has been actively bridging the connections with manufacturers and suppliers in China. Currently, Mr. Tan is the advisor of the Advisory Mission for Economy and Social Development of Yunnan Province, China; President of the Malaysia-China Chamber of Commerce; Secretary General of the Malaysia-China Friendship Association.

- **…has formed high barrier to entry.** Our background search reveals that these suppliers have established entrenched positions in China and have long operating track records. For instance, Peking Tong Ren Tang, a listed company in Hong Kong and Shanghai stock exchanges, has been in existence since 1669. These long-term strategic tie-ups with Chinese suppliers have formed a substantial barrier to entry for the TCM market in Malaysia. No other company in Malaysia has similar ties with Chinese suppliers currently. In comparison, Eu Yan Sang's products are mainly manufactured in Malaysia.

- **Increasing contribution from Pu-er tea.** Within the wholesale and retail segment, contribution from Pu-er tea is growing significantly. In FY04/07, the sales of Pu-er tea accounted for more than 20% (ie: RM9.7m) of the total wholesale revenue from 5% last year. This rising demand is because of its medicinal value, where market researchers have found that the consumption of Pu-er tea regularly could reduce cholesterol in the bloodstream and prevent the formation of cancer cells in the body due to its anti-oxidants. Unlike other teas that should ideally be consumed shortly after production, Pu-er tea can be drunk immediately or aged for many years. Going forward, we expect Pu-er tea contribution to increase to 25% of TCM wholesale and retail revenue in FY4/08.

Multi-level Marketing

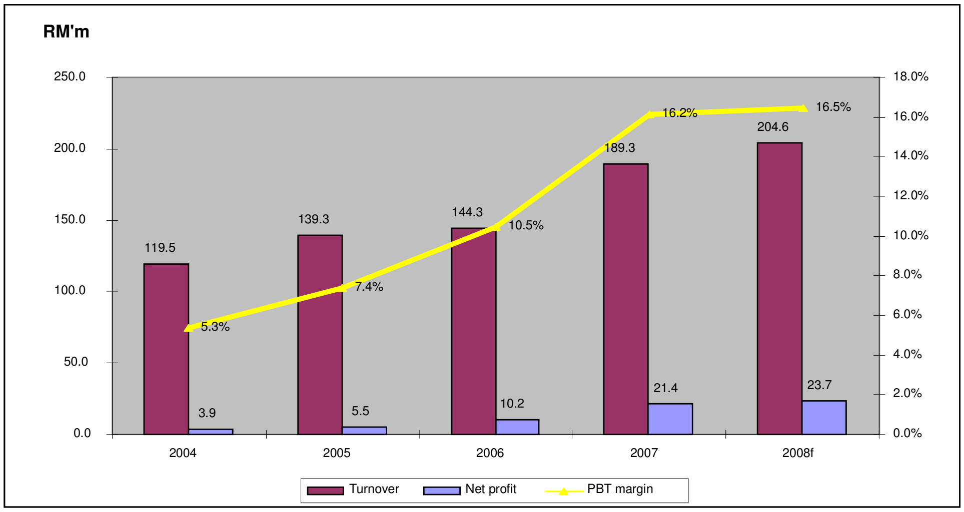
- **Decent MLM sales growth.** The MLM segment serves as an engine of growth for Haio. Over the last 3 years, revenue grew at a CAGR of 40% pa, underpinned by the increase in the number of core distributors at an average of 10,000 p.a. to the current 60,000 members. Of this, 90% of the core distributor force is Malay ethnic. Thanks to the generous MLM payout scheme of 65% as compared to market average of 50-60%, the number of new distributors is expected to continue to grow by 1,000 per month for the next 2 years. Meanwhile, distributor productivity is also on an increasing trend. The average revenue per distributor increased to RM1,600 per distributor in FY04/07 from RM1,100 per distributor a year ago. Going forward, we project the number of distributors to grow at 12,000 pa while distributor productivity is expected to increase by RM50-100 per distributor per annum for FY04/08-09. Collectively, we expect revenue from the MLM division to grow by between 12-21% in FY04/08-09. We believe this is achievable on the back of the RM8.0bn civil servant pay hike effective July 2007, as the majority of Haio's distributors and target customers are Malay ethnic.

- **MLM core product – Premium beautiful foundation lingerie.** Haio's MLM products basically can be categorised into beauty & wellness, food nutrition, household and car care and accessories, and water treatment systems. The top selling product is the premium beautiful foundation lingerie series (see appendix A), which contributed about 60% (ie: RM60m) of total MLM sales in FY04/07. Profit margin for this product is one of the highest out of all Haio's MLM product at about 15%. We expect this product to continue to be the main contributor in the MLM segment in FY04/08-09.

Earnings Outlook

- **FY2007 wrap up.** Haio's net profit grew at a CAGR of 76% pa over the past 3 years, underpinned by increasing contribution from the MLM division (led by a 45-50% increase in distributors and distributors' productivity over the 3-year period). Besides that, PBT margins have been on an increasing trend due to a favourable product mix, a reduction in interest expense and disposal of a loss-making subsidiary (see Chart 4).

Chart 4: Strong Historical Performance



Source : Haio & RHBRI

- Looking forward, we expect FY04/08-09 net profit to grow at 11-13% pa to account for: 1) the increase in MLM's distributor force as well as rising distributor productivity; 2) the opening of 4 new outlets in FY04/08-09, bringing Haio's retail outlets to 64 by FY04/08; and 3) an increase in demand for the higher margin-yield Pu-er tea.

- **Improving balance sheet quality.** Haio's balance sheet quality is improving with net cash of RM20m as at FY04/07 (from RM8.7m a year ago). This is due to the low capex requirements and a shorter debtor collection period vis-à-vis creditor payment period. Haio's capex requirement is usually capped to expenses relating to the opening of new retail outlets, which could be easily financed internally from the cash-generating retail business. Moreover, the payback period is relatively short at 1 year, as Haio's retail outlets usually start generating profits in the first year of operations. As such, Haio would not have any problem leveraging up its balance sheet should it want to explore a new venture in the future.

- **Strong dividend in the making.** Haio has formalised a dividend policy to distribute at least 50% of net profit to shareholders. Historically, Haio has been franking an average of 70% of net profit in the past 4 years to shareholders. It paid out 55% of net profit in FY04/07. We have projected a net dividend of 11.7 sen in FY04/08 or net payout ratio of 41%. This will translate into a reasonable net yield of 4.4%, which will add to the appeal of the stock.

- **Transfer to the main board.** Haio is in the midst of transferring its listing to the Main Board of Bursa Malaysia. We expect the transfer to be completed in October. To improve stock liquidity, Haio has recently issued bonus shares on a 1-for-5 basis, thus raising its outstanding shares to 83m from 69m.

Valuation

- As Haio's business nature is similar to other consumer stocks in our portfolio in terms of its cash generating capability, we are benchmarking Haio to our portfolio of consumer stocks (see Table 2). We attach a 40% discount to our target CY08 PER of 16x for the consumer sector in valuing Haio. We consider the 40% discount fair: 1) given Haio's relatively small market capitalisation; 2) below sector average EPS growth; but 3) slightly higher than sector average net dividend yield (see Table 2). Indicative fair value is RM3.13 based on 10x CY08 EPS. Given the upside potential of 19% vis-à-vis our estimated upside potential of 13% for KLCI, we initiate coverage of Haio with an **Outperform** recommendation.

Table 2: Peer comparison

Company	Share price	Market cap	EPS growth FY2007	EPS growth FY2008	EPS growth FY2009	PE FY2007	PE FY2008	PE FY2009	Net dividend yield FY2007	Net dividend yield FY2008	Net dividend yield FY2009
	(RM)	(RM'mil)	(%)	(%)	(%)	(x)	(x)	(x)	(%)	(%)	(%)
AEON	10.20	1790.1	14.3	18.2	20.3	17.5	14.8	12.3	1.1	1.3	1.3
Amway	6.80	1117.8	2.8	2.6	-0.1	18.0	17.5	17.5	5.4	5.4	5.5
BAT	41.00	11706.7	8.2	12.3	2.7	15.0	13.4	13.0	6.2	6.4	6.6
Carlsberg	4.70	1448.0	-34.2	33.4	12.6	25.4	19.0	16.9	5.4	5.5	5.6
KFC	6.30	1249.1	6.0	7.8	8.0	11.9	11.0	10.2	2.9	3.5	3.6
Padini	2.45	322.1	11.0	6.1	15.5	10.1	9.5	8.3	3.7	3.8	3.8
RCE	0.85	549.4	39.2	28.0	22.2	12.6	9.8	8.0	0.9	0.9	0.9
Average			6.8	15.5	11.6	15.8	13.6	12.3	3.7	3.8	3.9
Average (exc RCE)			1.4	13.4	9.8	16.3	14.2	13.0	4.1	4.3	4.4
Haio	**2.62**	**217.5**	**105.3**	**8.4**	**13.1**	**9.9**	**9.2**	**8.1**	**4.2**	**4.4**	**5.1**

Table 3: Earnings Review And Forecasts

FYE April (RM'm)	2006	2007	2008F	2009F	2010F
Turnover	**144.3**	**189.3**	**204.6**	**234.1**	**262.7**
COGS	-93.8	-121.2	-129.9	-147.5	-165.5
Gross profit	50.5	68.2	74.7	86.6	97.2
EBITDA	**17.5**	**0.0**	**0.0**	**0.0**	**0.0**
Depreciation and amortisation	-2.2	-8.0	-2.2	-2.4	-2.5
EBIT	**15.3**	**-8.0**	**-2.2**	**-2.4**	**-2.5**
Net interest expenses	-0.3	0.1	0.6	0.8	1.1
Associates & JV	0.2	0.0	0.0	0.0	0.0
Pretax profit	**15.1**	**30.6**	**33.7**	**38.1**	**42.6**
Taxation	-4.3	-8.5	-9.1	-10.3	-11.5
Minorities	-0.6	-0.7	-0.8	-1.0	-1.1
Earnings	10.2	21.4	23.7	26.8	30.0
Chg (%)	84.9	110.0	11.0	13.1	11.8
EPS (sen)	**12.8***	**26.4***	**28.6**	**32.3**	**36.2**
Chg (%)	84.1	105.3	8.4	13.1	11.8
PER (x)	**20.4**	**9.9**	**9.2**	**8.1**	**7.2**
Net dividend per share (sen)	4.8*	11.0*	11.6	13.3	14.9
Net dividend yield (%)	1.8	4.2	4.4	5.1	5.7
Effective tax rate (%)	28.8	27.8	27.0	27.0	27.0
Balance Sheet	**2006**	**2007**	**2008F**	**2009F**	**2010F**
PPE	45.0	45.4	48.4	49.2	49.6
Intangibles	0.3	0.3	0.3	0.3	0.3
Others	9.3	8.1	6.6	6.6	6.6
Total fixed assets	54.6	53.8	55.3	56.1	56.5
Inventories	28.1	33.9	35.6	40.4	45.3
Trade receivables	15.5	15.0	22.4	25.7	28.8
Cash	13.1	27.7	33.8	45.5	59.1
Other	13.9	18.6	18.6	18.6	18.6
Total current assets	70.6	95.2	110.4	130.2	151.9
Payables	5.8	21.6	23.4	27.1	30.3
Borrowings	4.4	7.4	7.4	7.4	7.4
Others	21.0	9.0	9.0	9.0	9.0
Total current liabilities	31.2	38.0	39.9	43.5	46.8
Share cap	66.3	68.8	83.0	83.0	83.0
Retained profit	22.4	37.2	38.3	54.3	72.1
Others	0.6	-0.3	-1.6	-1.6	-1.6
Total shareholders' funds	89.4	105.7	119.7	135.7	153.5
MI	4.6	5.2	6.1	7.0	8.1

Deferred tax liabilities	0.0	0.1	0.1	0.1	0.1
Current ratio (x)	2.3	2.5	2.8	3.0	3.2
Net cash/(debt) (RM'mil)	8.7	20.3	26.4	38.1	51.7
Net gearing (x)	Net cash	Net cash	Net cash	Net cash	Net cash
NTA/share (x)	1.3	1.5	1.4	1.6	1.8
ROE (%)	5.9	11.0	10.5	10.5	10.4
Cash Flow statement	**2006**	**2007**	**2008F**	**2009F**	**2010F**
CFO	11.2	28.0	21.0	25.9	28.7
CFI	-11.7	-11.5	-5.2	-3.2	-2.9
CFF	-3.8	-2.4	-9.7	-10.9	-12.2
CFO/share (sen)	16.8	40.6	25.3	31.1	34.6
FCF/share (sen)	-0.8	23.9	19.0	27.3	31.1

* Adjusted for bonus issue for light-to-light comparison

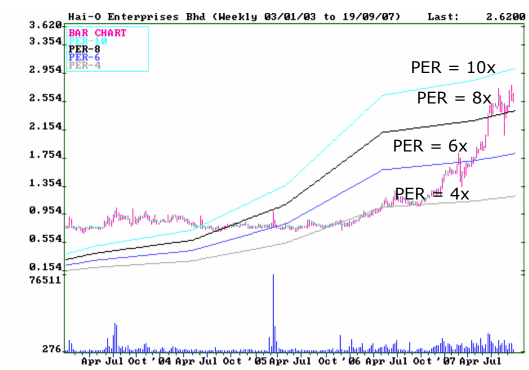
Appendix A

Products	Description
 **Baji Chiew**	Composed of a variety of valueable herbs of which Baji herbal root serve as the major ingredients. Reinforces the kidney and lumba, alleviating backaches, headaches, soar muscles and preventing frequent urination, aging, indigestion, arthritis.
 **Yang Sheng Chiew**	Yang Sheng Chiew is brewed following the traditional method. It is composed of superior grain together with the famous herbal medicines produced at Huai Qing Fu of Henan Province - The Rhizoma Dioscoreae Batatas, the Radix Rehmanniae, the Radix Achyranthis Bidentatae and Flos Carthami, as well as other rare and costly medicinals by more than 20 species such as Radix Ginseng, Agkistrodon Halys, Caulis Dendrobii, Radix Astragali, Cortex Eucommiae, Semen Cuscutae..etc.
 **Ling Zhi Medicated Liquor**	Ling Zhi (Garnoderma Licidum) is fungus, mild and beneficial to health, it has been used by people ling ago as a herbal remedies. Regular intake will improve the body's function and maintain good health.
 **Shao Hsing Hua Tiao Chiew**	Shao Hsing Hua Tiao Chiew is a well-known traditionally speciality and the oldest brewed wines in China. It is brewed from pure grains and containing low alcohol. As a drink, it is effective in improving blood circulation, complexion and appetite. In the kitchen, it is used for expelling fishy smell and for seasoning.

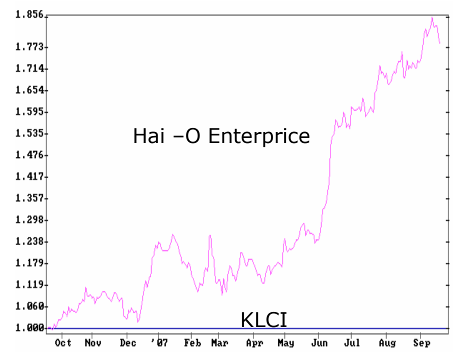
 **Wu Jia Pi Chiew**	Traditionally used to expel wind and for general health.
 **Imperial Tea**	Imperial tea (Pu-Er) is a large leafed and suncured tea from the Yunnan province in China and has been famous as a medicinal tea. The earliest records of Pu-Er tea dated back to the Tang Dynasty (618 AD – 906 AD).
 **PREMIUM BEAUTIFUL FOUNDATION LINGERIE**	Cut based on the body's three-dimensional design using stereoscopic infrared rays for absolute presicion and delicacy. It helps blood circulation and metabolism creating complete synergy with the human body.

Source: www.hai-o.com.my and www.hai-omarketing.com.my

PE Band Chart



Relative Performance To KLCI



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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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