15 January 2008

AFFIN INVESTMENT BANK

Company Update

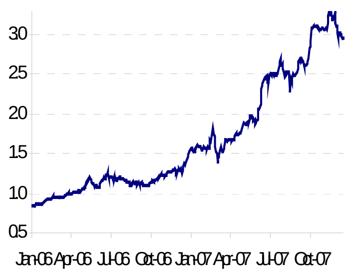
Hai-O Ent

HAIO MK

RM3.26

BUY (maintain)

Target Price: RM4.18



Price Performance

	1M	3M	12M
Absolute	10.1	5.2	104.8
Rel to KLCI	2.6	-4.0	53.2

Stock Data

Issued shares (m)	82.6
Mkt cap (RMm)	269.2
Avg daily vol - 6mth (m)	0.1
52-wk range (RM)	1.36-3.40
Est free float	50%
NTA per share (RM)	1.5
P/NTA (x)	2.2
Net cash/ (debt) (RMm) (July 07)	68.9
ROE (2008F)	26.5%
Derivatives	Nil

Key Shareholders

Tan family	25.6%
Maybank Smallcap	3.9%

Earnings & Valuation Revisions

	08E	09E	10E
Prev EPS (sen)	37.4	44.1	52.0
Curr EPS (sen)	37.4	44.1	52.0
Chg (%)	-	-	-
Prev target price (RM)			4.18
Curr target price (RM)			4.18

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Putting long-term growth drivers in place

Upbeat on prospects of new MLM venture in Indonesia

We are optimistic on the longer term prospects of Hai-O's new MLM venture in Jakarta – expected to commence operations in mid 2008, by replicating its successful MLM business model here. Indonesia, in our view, offers a huge untapped market for Hai-O given: 1) its huge consumer market with a population base of nearly 10x that of Malaysia; 2) growing young population - half the population is below age of 25; 3) high income base of urbanites - per-capita income in Jakarta of US$4,500/year is close to Malaysia's national per-capita income of US$5,490/year, and 4) Indonesia shares similar demographics and taste as that of Malaysia.

New export market – China and Hong Kong, equally as exciting

Meanwhile, a new export division (at preliminary stage of establishment) to tap into the fast growing China, Hong Kong and Middle East markets. Hai-O intends to export its own local brand products such as Tongkat Ali Coffee, bird's nest and vitamin supplement known as "Tri-E" (a form of natural vitamin E capsule). We view this move positively given the huge potential of bird's nest and Tri-E in these markets.

Source of new growth drivers if new ventures take off successfully

Until there is better clarity on the successful launch and take off of the new ventures with revenue streams flowing in, we will not impute any earnings contributions from them into our earnings forecasts. However, if successful, these new markets may provide new source of growth drivers to Hai-O. Meanwhile, exposure risk is low given the minimal capital commitment involved – at around US$0.5m for the Indonesia JV.

Maintain FY08-10 earnings, projecting 3-year EPS CAGR of 32%

All in all, we are positive on both developments as they put Hai-O's longer-term growth drivers in place. Hai-O will be positively re-rated should contributions from these operations materialise sooner-than-expected. We maintain our FY08-FY10 EPS forecast, which translates into a strong 3-year CY07-10 EPS CAGR of 32%.

Maintain BUY, target price of RM4.18 yielding a 24% upside

Maintain BUY on Hai-O with a target price of RM4.18 based on SOP. We continue to like Hai-O for its: 1) fast expanding MLM division; 2) robust 3-year EPS CAGR of 32% over CY07-10; 3) highly attractive valuations – FY04/08 PE of 8.7x, and 4) excellent FY08-10 dividend yields of 6%-8%.

Earnings and Valuation Summary

FYE 30 April	2005	2006	2007	2008F	2009F	2010F
Revenue (RMm)	141.5	146.8	189.3	256.4	294.6	339.8
EBITDA (RMm)	13.5	17.3	32.6	46.4	53.9	62.9
Pretax profit (RMm)	10.3	15.1	30.6	43.1	50.1	59.4
Net profit (RMm)	5.5	10.2	21.4	30.9	36.7	43.5
EPS (sen)	8.0	12.4	26.0	37.4	44.1	52.0
EPS growth (%)	41.7	55.2	110.0	43.6	18.2	17.8
PER (x)	40.9	26.3	12.5	8.7	7.4	6.3
Core net profit (RMm)	5.5	10.2	21.4	30.9	36.7	43.5
Core EPS (sen)	8.0	12.4	26.0	37.4	44.1	52.0
Core PER (x)	40.9	26.3	12.5	8.7	7.4	6.3
DPS (sen)	5.0	6.7	15.1	19.2	22.4	27.2
Dividend Yield (%)	1.5	2.1	4.6	5.9	6.9	8.3
EV/EBITDA (x)	16.4	15.1	7.3	5.1	4.1	3.2
Consensus profit (RMm)				26.6	31.4	43.5
Affin/Consensus (x)				1.2	1.2	1.0

Indonesian MLM venture to commence operations in mid-2008

Hai-O's new MLM venture (vide a 70%-owned JV) in Jakarta, Indonesia is expected to commence operations in mid-2008. The JV will replicate its successful Malaysian MLM business model. Bulk of the preparation work had already been undertaken, including the registration of companies. The relevant approvals required for the distribution of traditional Chinese medicine have also been sought. Meanwhile, non-consumables such as beauty products and water filters, which accounted for 88% of FY07 MLM turnover, are exempted from the authority's approvals, thus reducing the risk of delays in products rollout. The local distributor force has also started its networking exercise, and once a MLM licence is issued, recruitment and agency build-up will go into full swing. Management has allocated a minimal capex of USD0.5m for the expansion.

Optimistic on the new Indonesian venture – demographics supportive

We note that the return on investment of Hai-O's MLM business in Malaysia, which was established in 1992, was fast at less than 1.5 years given the minimal capital invested. While we believe that the return in the new Indonesian venture will likely be fast, mirroring the success of its Malaysian experience, we have however not imputed any contributions from Indonesia into our forecast. Our optimism is underpinned by the following considerations: 1) Indonesia's largely untapped and huge consumer market with a massive population of nearly 10x that of Malaysia; 2) its growing young population - half the population is below the age of 25; 3) high income base of urbanites with Jakarta's per-capita income (US$4,500/year) close to Malaysia's national per-capita income (US$5,490/year), and 4) Indonesia shares similar demographics and taste (refer to Appendix 1 for detail comparisons of the two countries' demographics and MLM business).

Two-tier market segment in Indonesia

Hai-O plans to target two different market segments based on its products range in Indonesia; 1) mid to high level income – beauty products and water filter; and 2) mass market – small ticket items such as healthcare and food products. We believe this strategy is feasible given the widening disparity in income levels between the rich and poor where urbanites earn 4x higher than the rural folks (e.g. urban workers earn an estimated US$4,500/year in Jakarta vs rural workers average of US$1,000/year in Kalimantan). This means Indonesia's income distribution is skewed towards Jakarta and we note that Jakarta's per-capita income of US$4,500/year is similar to that of Malaysia's national per-capita income of US$5,490/year. This offers a huge potential market for Hai-O. In addition, rapid urbanization (approx 3.8m Indonesians moving to the cities each year) will provide a pool of growing households and expanding market.

New markets - targeting bird's nest for China and Hong Kong

Separately, Hai-O reiterated its plans to tap into the fast growing China, Hong Kong and Middle East markets. It intends to export its own local brand products such as Tongkat Ali Coffee, bird's nest and vitamin supplement known as "Tri-E" (a form of natural vitamin E capsule) for which it has been granted exclusive sales and distribution rights in China by Golden Hope Bioganic Sdn Bhd. Management has guided that bird's nest will be the key product largely due to the high demand in China and Hong Kong, as both countries have been increasing imports from Malaysia, Thailand, Indonesia and Vietnam.

Tri-E to meet China's growing nutraceutical demand

The "Tri-E" vitamin supplement (to reduce risk for coronary heart disease, cancer and premature-aging related diseases) is anticipated to contribute positively. China is a fast growing nutraceutical market as strong economic growth has led to the extensive upgrading and diversification of food, beverage and pharmaceutical demand. An independent research survey indicates that world demand for vitamins in nutraceutical products will increase 4.6% annually to nearly US$4.2bn in 2010. If anything, the stumbling block is the fairly long process in obtaining regulatory approvals, as it can take 6 months to a year. Until there is better clarity on the commencement of sales, we will not factor this new market into our earnings forecast.

Key risks lie in slower consumption and ROI

Key risks lie in: 1) slower than expected ROI, 2) failure to tackle consumer needs and preference; 3) long gestation of healthcare and food products registration; and 4) inconsistencies in the law are not unusual (particularly when foreign companies are involved). As such, we have not imputed any impact from the Indonesia operations and new export markets into our forecast. However, if successful, these could potentially provide new growth areas to Hai-O.

Maintain FY08-10 earnings: 3-year CY07-10 EPS CAGR of 32%

We maintain our FY08-FY10 EPS forecast, which translates into a strong 3-year CY07-10 EPS CAGR of 32%. We expect gross profit margins to be sustainable at around 36-39% due to management's continuing efforts to: 1) push higher value and margins products; 2) introduce higher-priced branded and quality products (1-2 new products pa), and 3) stronger ringgit against US$ which benefits Hai-O's MLM business (imports account for 50%-60% of group purchases). Our earnings model reflects a fairly flat albeit marginal improvement in EBIT margin to 16.8% in FY08, 16.9% in FY09 and 17.3% in FY10.

Maintain BUY, target price of RM4.18 yielding a 24% upside

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Fig 1: SOP valuation of RM4.18

Divisions	CY08 net profit (RM m)	Applied PER (x)	Value (RM m)	Comments
MLM	18.9	9	169.9	Target PER at a 10% discount to industry MLM average
Retail	1.8	9	16.7	Retail franchise PERs range from 11x-20x
Wholesale	13.2	7	93.1	Fair PER for a fairly stable business
Manufacturing	0.6	9	5.3	Regional pharmaceutical companies trade between 9x-44x
Others	2.0	4	8.1	Reasonable for its traditional Chinese clinics
Net cash/debt			52.6	
			345.6	
No of shares (m)			82.7	
SOP/share			4.18	

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

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