

## MALAYSIA EQUITY

## Initiating Coverage

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## Hai-O Enterprise

**BUY**  
Price **RM1.51**  
Target **RM2.01**

## Stock Profile/Statistics

Bloomberg Ticker	HAIO MK Equity
KLCI	1080.11
Issued share capital (m)	67.23
Market Capitalisation (RMm)	101.51
52 week High (RM)	1.57
52 week Low (RM)	0.94
Average Volume (3m) '000	48.81
YTD Returns (%)	0.57
5 yr Average ROE (%)	5.12
5 yr Average ROA (%)	3.66
Net gearing (x)	(0.17)
Altman Z-Score	3.42
ROCE/WACC	0.37
Beta (x)	0.83
Cash Ratio (x)	0.64
FCF/share (x)	0.16
Price/FCF/share (x)	7.98
Book Value/share (RM)	1.36

## Major Shareholders (%)

Tan Kai Hee & Family	21.5
Excellent Communication SB	5.3

## Share Performance

(%)	1m	3m	6m	12m
Absolute	8.9	20.5	22.3	62.1
Relative	(3.8)	(0.5)	0.1	26.1

## Growth Profile (%)

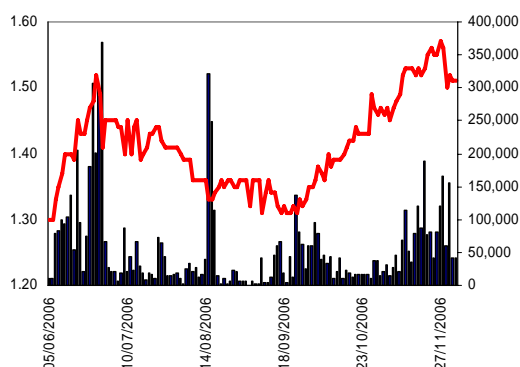
	05a	06a	07f	08f
Revenue	16.6	3.6	11.3	10.2
EBITDA	51.0	33.3	24.9	10.2
PBT	61.5	46.7	27.0	10.9
NP	41.6	84.9	28.4	12.5

## Margin (%)

	05a	06a	07f	08f
EBITDA	9.2	11.8	13.3	13.3
PBT	7.4	10.5	12.0	12.0
NP	4.0	7.1	8.1	8.3

## Historical Price Ratio

(x)	03a	04a	05a	06a
P/Sales	1.7	1.3	1.1	1.0
P/Earnings	102.9	26.0	18.4	9.9
P/Book	1.3	1.3	1.2	1.1



## Healthy Growth With Health Care Products

**The leading healthcare company** in Malaysia involved in wholesale, retailing, MLM, pharmaceutical factory and modern Chinese Medicinal Clinics with more than 30 years of experience.

**Having the right strategy.** Hai-O has disposed its non-core businesses, to improve operational efficiency. In addition, the company has been shutting down the non-performing retail stores and open more retail stores in other strategic locations.

**Own manufacturing division.** Hai-O has its own manufacturing division to supply quality traditional pharmaceutical products and food supplementary products.

**Potential in Multi-Level-Marketing (MLM).** MLM is the fastest growing division in the company with CAGR of more than 40% in the past 3 years.

**Strong earnings growth.** We expect Hai-O to register net earnings of RM13.1m and RM14.7m for FY07 and FY08 respectively. Net earnings growth is expected to be around **16% CAGR** from FY06-FY09.

**Attractive dividend yield.** We expect the company to pay dividend of 15 sen per share translating into yield of 9.9% based on the current share price.

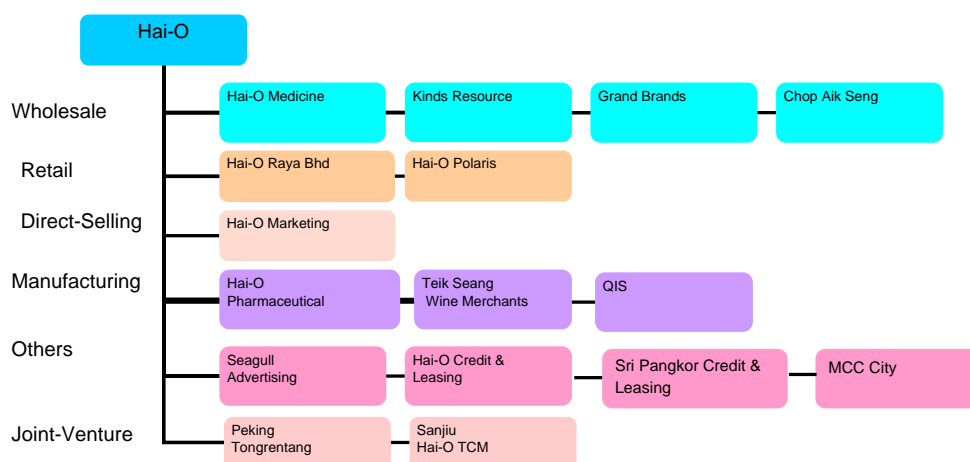
**Initiating with BUY.** We peg a fair value of RM2.01 by applying the composite average of 9x PER over FY08 EPS of 22 sen, P/BV of 1.3x and Gordon Growth model. We initiate coverage on the stock with a **BUY** recommendation.

FYE Apr (RMm)	FY04a	FY05a	FY06a	FY07F	FY08F
Total revenue	119.5	139.3	144.3	160.5	176.8
EBITDA	8.5	12.8	17.1	21.3	23.5
Pretax profit	6.4	10.3	15.1	19.2	21.3
Net Profit	3.9	5.5	10.2	13.1	14.7
% chg YoY	295.9	41.6	84.9	28.4	12.5
EPS (sen)	5.8	8.2	15.2	19.5	22.0
Gross DPS (sen)	2.1	2.5	8.0	15.0	16.0
Gross Div Yield (%)	1.4	1.7	5.3	9.9	10.6
PER (x)	26.0	18.4	9.9	7.7	6.9
BV/ share	1.20	1.22	1.33	1.42	1.52
P/BV	1.3	1.2	1.1	1.1	1.0
ROE (%)	4.8	6.8	11.9	14.1	14.7
ROA (%)	3.5	4.7	8.1	10.6	10.8

## BACKGROUND

**Long establishment.** Hai-O has since become a famous household name offering a wide range of Chinese medicines, medicated wines and health care products since 1975. The company was successfully listed on the Bursa Malaysia Securities Berhad in 1996, being the first traditional healthcare company on the stock exchange. The principal business of the company involves **wholesaling, retailing, multi-level marketing (MLM), pharmaceutical factory** and **modern Chinese Medicinal Clinics**. For the past three decades, Hai-O had honed its expertise by building extensive and efficient distribution network and strong marketing strategies.

**Figure 1: Corporate Structure**

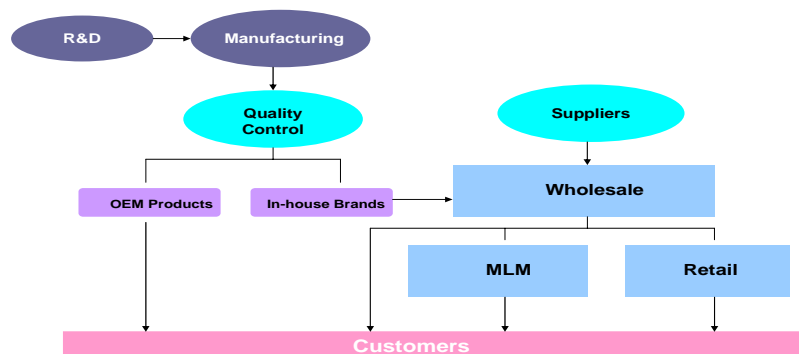


Source: Company

**An assortment of recognition.** Hai-O was the first local Chinese healthcare company to receive GMP (Good Manufacturing Practice) standards. The company was awarded the "Superbrand" status by the Malaysia Superbrand Council for the year 2003/2004. Other recognitions were including "Enterprise 50" award by SMIDEC and Delliotte, 2003; "Golden Bull Award" Malaysia's Top 100 Outstanding SMEs, 2003; and "Malaysia BOOK of Records" for greatest number of traditional healthcare chain stores in Malaysia 2001.

## VARIOUS SOURCES OF INCOME

**Figure 2: Business models**



Source: Company

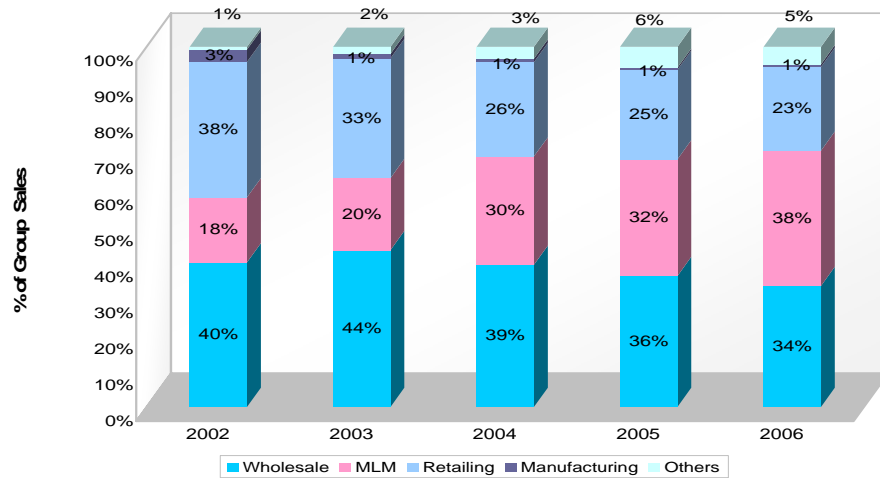
**Manufacturing.** Hai-O Pharmaceutical factory was established in 1994 with the technological support and know-how transfer from China. The products consists of two main lines namely traditional pharmaceutical products and food supplementary products approved by Drug Control Authority of Health Ministry. There products are manufactured under Hai-O's own brand names, "Hai-O" and "Seagull" and are approved by the Drug Control Authority of Health Ministry, Malaysia.

**Wholesale.** The wholesale division has more than 100 wholesalers and 3,000 retailers including Chinese Medical Halls nationwide carrying more than 200 brands of renowned Chinese medicines, wines, tea and healthcare products. This would be the pillar of growth as part of the Group's "Golden Triangle" strategy to focus on tea, traditional medicines and wine.

**Retail.** The retail division comprised of 23% of FY06 revenue. Currently there are 54 outlets, including 15 franchise shops and online E-Store. Hai-O Raya Customer Loyalty Program currently has more than 120,000 members.

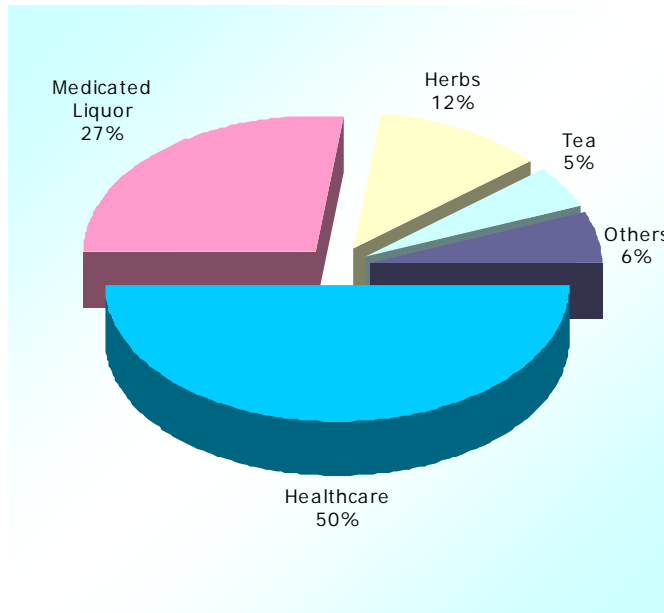
**Multi-Level-Marketing (MLM).** MLM is the fastest growing division in the company with CAGR of more than 40% in the past 3 years and is currently contributing to about 38% in the company's total turnover.

**Figure 3: Segmental breakdown**



Source: Company

**Figure 4: Sales mix**



Source: Company

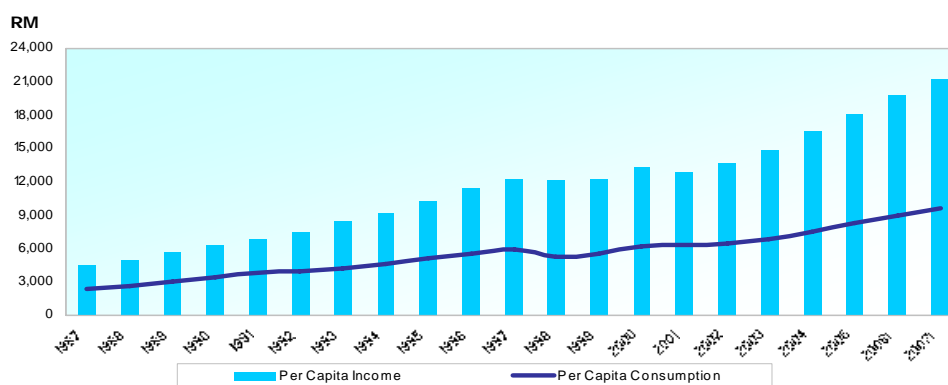
## EARNINGS DRIVERS

**Strong presence and wide network.** Hai-O is the first traditional herbal health care company with 54 outlets, including 15 franchise shops located throughout Peninsular Malaysia which adopt a truly homegrown franchise programme.

**Disposal of non-core business units.** Hai-O has disposed its non-core businesses, to improve operational efficiency. In addition, the company has been shutting down the non-performing retail stores and open more retail stores in other strategic locations. As a result, revenue in FY06 grew slower at 3.6% but EBITDA margin has improved from 8.2% in FY05 to 11.8% in FY06. We expect the EBITDA margin to further improve to about 13% for FY07.

**Driven by per capita income growth.** As shown in Figure 5, income per capita and consumption of Malaysians has been growing at an average rate of 8.1% and 7.5% respectively since 1987. The graph also shows that per capita consumption is growing inline with GDP. Going forward, the Ministry of Finance has forecasted consumption growth of 8.9% for FY06 and 7.5% for FY07 whereby Hai-O's business can surely benefit from. Hence, we expect store growth to be closely correlated that of the income per capita growth.

**Figure 5: Per Capita Income & Per Capita Consumption of Malaysians**



Source: BNM & MOF, OSK Research

**Huge potential in MLM.** MLM is the fastest growing division in the company with CAGR of more than 40% in the past 3 years. Currently it is contributing about 38% in the company's total turnover and will highly increase in the future. Currently this division has been the fastest growing division in the past 3 years with CAGR of more than 40%. This division has over 34,000 distribution agents, and over 50 stockists & branches nationwide. Active members in MLM have increased from 14% in 2002 to about 30%. We expect active members to increase as the management has stress the importance of this division by effective training programme.

**Promoting "Pu-Er" tea as its growth driver.** "Pu-Er" tea is a premium grade of tea which has health benefits and the only tea which increase in investment value over time. Hai-O has secured the sole distributorship of "Pu-Er" tea from several established "Pu-Er" producer in Yunnan Province. The group has made Pu-Er tea as one of its core products and plans to expand its business of this unique tea in the next few years. For FY06, Pu-Er tea has contributed approximately 10% of the group's total PBT. Besides Pu-Er tea, additional revenue and earnings contribution by new products/new agencies from China such as Fu Yuan Tang series products (ie. Ganoderma Lucidum Spore Cordyceps Sinensis Capsule, G-Balance Capsule, Ganoderma Lucidum), Bio Aura Energy Water Filter and other house-owned brand products launching during the year.

**Strengthening of Ringgit beneficial to the company.** Import account for 60% of the group's total purchases. We expect for every 1% appreciation in Ringgit, Hai-O's gross profit margin will be increased by 0.3%-0.4%.

**Various promotions.** Hai-O has participated in various exhibitions in Malaysia and overseas to promote its product. To further improve market share, the group will penetrate the English-educated society through internet promotions and advertisements in English dailies. In anticipation of Beijing 2008 Olympics, Hai-O has and will organise various activities with China branded products as the main theme.

**Halal certification on selected products.** The halal certification on selected products enables Hai-O to have an edge over other Chinese traditional medicine and supplements products sellers to tap into the Malay market in Malaysia and 90% of its products channelled through MLM are purchased by the Malay community. Moreover, with the halal certificate, this can be a great opportunity to penetrate the Middle-East countries.

## FINANCIALS

**Double digit earnings growth for the next 3 years.** We expect Hai-O to register net earnings of RM13.1m and RM14.7m for FY07 and FY08 respectively, boosted by rapid growth in MLM division and disposal of non-profitable business. Net earnings growth is expected to be around **16% CAGR** from FY06-FY09. Balance sheet is strong with net cash per share of 18 sen as at 31 July 2006.

**Attractive dividend yield.** Hai-O has promised to pay at least 50% of net profit as dividend to shareholders. For FY07, we expect the company to pay dividend of at least 15 sen per share translating into yield of 9.9%.

**Valuation.** We peg a fair value of RM2.01 by applying the composite average of 9x PER over FY08 EPS of 22 sen, P/BV of 1.3x and Gordon Growth model. With potential upside of 33% and strong dividend yield of 8.4%, we initiate coverage on the stock with a **BUY** recommendation.

**Figure 6: Valuation method**

Valuation	Price
NTA/share	2.01
PER	1.98
Gordon growth model	2.04
<b>Average</b>	<b>2.01</b>

Source: OSK Research

### OSK Research Guide to Investment Ratings

**Buy:** Total return of the stock may exceed 10% OR outperform the relevant benchmark index over the next 12 months, whichever is higher

**Trading Buy:** Total return of the stock may exceed 10% over the next 3 months, however longer-term outlook remains uncertain

**Neutral:** Total return of the stock may fall within the range of +/- 10% (inclusive) over the next 12 months OR is not expected to outperform or underperform the relevant benchmark index by the same quantum over the same period

**Take Profit:** Target price has been attained. Look to accumulate at lower levels.

**Sell:** Total return of the stock may fall more than 10% OR underperform the underlying benchmark index over the next 12 months

\* Total Return (capital gain + dividend yield)

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