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Hai-O Enterprise Bhd

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14 March 2006

Consumer-Related

BUY

KLCI	**922.03**
Share Price	**RM1.13**
New 12-mth Target	**RM1.45**
Prev. 12-mth Target	**-**
Prev. Rec.	**-**
Upside To Target	**28.3%**

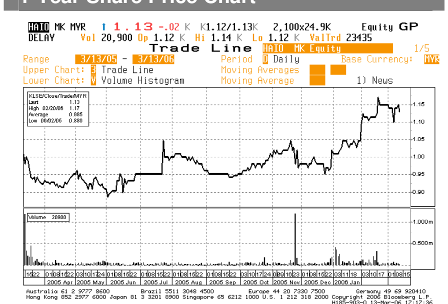
Stock Codes	
Bloomberg	HAIO MK
BMSB	HAIO/7668

Stock and Market Data	
Listing	Second Board
Syariah Compliance	No
Shares In Issue @ RM1.00	69.6m
Market Cap	RM78.7m
3M Ave Daily Vol	75,726
Est. Free Float	40%
52 Week Hi/Lo	RM1.20/RM0.86

Fundamentals – FY06F	
ROA	7.2%
ROE	9.2%
Net cash (RM'mil)	RM18.4m
Free Cash Flow	RM9.3m
Tax Rate	30.0%

Shareholders	
Tan Kai Hee & Family	21.5%
Excellent Communication Sdn Bhd	5.4%

1-Year Share Price Chart



Source: Bloomberg

Share Performanc	1M	3M	12M
Absolute	1.4%	14.1%	18.5%
Relative to KLCI	1.6%	10.7%	11.4%

Pioneer in the MLM industry

- **BUY, with a fair value of RM1.45/share.** We are calling a BUY on Hai-O, at a fair value of RM1.45/share. Our fair value, with 28.3% upside, is based on our projected CY06 EPS of 15.2sen against a target PER of 9.5x.
- **Strategy.** Management is on the verge of disposing its non-core businesses in a move to improve operational efficiency. By doing so, ROE is expected to improve tremendously as the non-performing/core assets will eventually be disposed off.
- **Financial position to remain commendable.** Cash ratio improved to 0.56x in FY05 from 0.45x in FY02, while cash flow position has improved to net cash of RM12.0m from net debt of RM5.1m in FY02. Going forward, we expect Hai-O to remain as a net cash company, as a result of the resilient growth expected, as well as the minimal capital expenditure required going forward.
- **GDPS of 6sen.** Despite the proposed share dividend is expected to dilute Hai-O's future EPS, management indicated that GDPS going forward is expected to increase to 7-8sen going forward.
- **Earnings prospects.** For FY06, even though revenue is only expected to rise by 6.2% to RM147.8m, PBT is anticipated to amplify by 29.1% to RM13.3m. The higher PBT should result from overall improvement in its profitability margins, particularly from the MLM, wholesale and manufacturing divisions. For FY07, we expect PBT to improve by 33.1% to RM17.7m as it bears fruits from its re-branding exercise.

EARNINGS & VALUATION PROFILE

FYE 30 Apr (RM'mil)	FY03	FY04	FY05	FY06E	FY07F
Revenue	89.0	119.5	139.3	147.8	161.9
Growth	*6.2%*	*34.3%*	*16.6%*	*6.2%*	*9.5%*
EBIT	4.2	6.7	10.7	13.5	17.8
Growth	*2.5%*	*59.7%*	*59.4%*	*25.8%*	*32.3%*
Margin	*4.7%*	*5.6%*	*7.7%*	*9.1%*	*11.0%*
PBT	3.5	6.4	10.3	13.3	17.7
Growth	*45.3%*	*83.7%*	*61.5%*	*29.1%*	*33.1%*
Margin	*3.9%*	*5.3%*	*7.4%*	*9.0%*	*10.9%*
Net profit	1.0	3.9	5.5	8.9	11.8
Growth	*86.3%*	*296.3%*	*41.7%*	*60.8%*	*33.1%*
Margin	*1.1%*	*3.3%*	*4.0%*	*6.0%*	*7.3%*
EPS (sen)	1.4	5.6	7.9	12.7	16.9
GDPS (sen)	3.7	4.6	5.3	7.0	7.0
PER (x) @ RM1.13	80.2	20.2	14.3	8.9	6.7
Yield @ RM1.13	3.3%	4.1%	4.7%	6.2%	6.2%

Source: SBBSR

BUSINESS PROFILE

Hai-O Enterprise Bhd is involved in the distribution and wholesale of medical products, representing more than 10% of the top brand Chinese manufacturers in Malaysia. Through its subsidiaries, the company operates 57 retail stores, provides multi-level marketing (MLM), manufacturing, and leases machinery and equipment.

To date, it has a distribution network of some 3,000 trade customers and over 20,000 distributors in its MLM division.

DETAILS OF HAI-O's BUSINESS SEGMENTS	
Wholesale	Wholesaling and trading of Chinese and Western wines, herbs, medicines and tea.
Retail	Operating retail chain stores.
Multi level marketing (MLM)	Operating multi level direct marketing of healthcare and beauty products.
Manufacturing	Manufacturing, producing and distributing pharmaceutical products, alcoholic and non-alcoholic beverages.
Others	Leasing of machinery and equipment; licensed moneylender; insurance agent; advertising services; rental income; organising promotion events; trading of clocks; and investment holding.

Source: Hai-O Enterprise Bhd

INDUSTRY OUTLOOK

Highly competitive

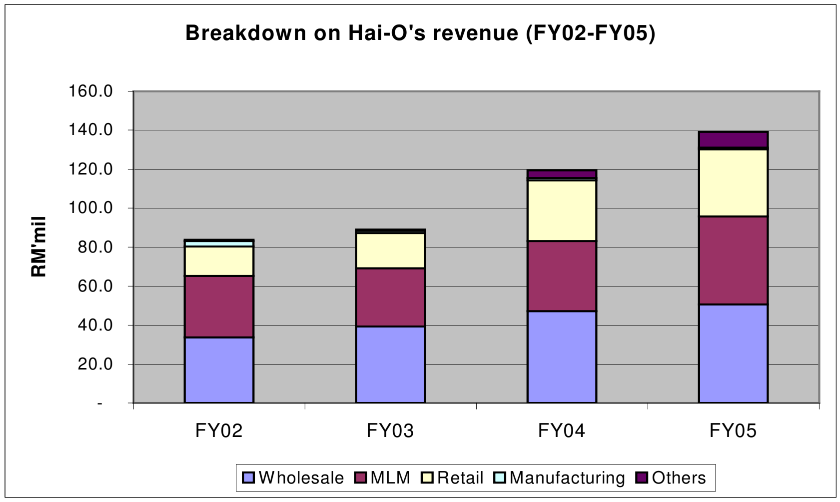
The direct sales industry in Malaysia is highly competitive, where the number of MLM players augmented to 333 companies in October 2005 from 259 companies in 2003 (Source: www.kdpnhep.com.my), due to the loose regulation imposed as well as low start-up cost. Distributors in MLM structure generally focus on creating more distributors that form down liners. They accumulate points through the sales of products, which are then converted to monetary rewards.

Brand name is important

However, brand names play an important role in determining the sustainability of any particular MLM player, as it assures and guarantees the products and services offered by the MLM players. As an indication, there are currently less than 100 players in the Direct Selling Association, due to the stringent regulation on healthcare products. These members are contributing more than 80% of the total sales volume in the MLM industry.

INVESTMENT HIGHLIGHTS

In FY05, wholesale, MLM and retail divisions accounted for 93.6% and 98.4% of Hai-O's revenue and operating profit.



Source: SBBSR

Over 14 years history in the MLM industry

MLM division. Hai-O Marketing Sdn Bhd, a wholly-owned subsidiary of Hai-O, is a pioneer in the MLM industry, which has 14 years of experience in the industry. Revenue contribution from this division has increased to 32.4% of the group's revenue in FY05 from 30.1% in FY04.

Over the years, revenue contributors for the MLM division has shifted from Chinese consumers to Malay consumers, due to a drastic change in the local consumption patterns, and Malay consumers currently contribute more than 90% of the MLM division's revenue.

We expect the MLM division to register a double-digit growth for FY06 and 07, mainly due to our expectation increased in productivity of active Bumiputera members, as the commission payout ratio granted for Hai-O's distributors is one of the highest in the market.

Wholesale division's contribution to remain sizeable going forward

Wholesale division. Hai-O is the pioneer, with more than 30 years of history in distributing Chinese medical products in Malaysia. Wholesale division's revenue contribution to the group has dropped to 36.3% in FY05 from 39.5% in FY04. The decline in revenue contribution was mainly because of its slower growth relative to other divisions.

Going forward, topline growth for the wholesale division is expected to remain less robust compared to the other divisions, as this division is mainly targeted on Chinese centric medical halls. However, bottomline contribution from this division is expected to increase, as a result of its recent strategic tie-up with Peking Torentang, Shenzen Sanjiu and other several principals in China, which is expected to further broaden the product range.

Retail division reported robust growth

Revenue from retail division has been growing steadily at 3-year CAGR of 31.8% between FY02 and FY05, in line with its strategy in broadening product accessibility. Hai-O added five new outlets in FY05, bringing the total number of retail chain stores to 57.

In the meantime, the group is exploring the concept of integrated health food store and TCM clinic, in order to complement the existing retail stores by providing additional treatment services to customers.

Partnering with Giant

In response to the changing shopping trend in Malaysia, Hai-O has established a specially arranged business partnership with *The Giant* hypermarket by setting up specialty counters in this hypermarket chain. Hai-O has so far set up two specialty counters in the Giant Tambun, Ipoh and Giant Plentong Johor.

Besides having business partnership with Giant, Hai-O has also set up a specialty counter in Jusco, Seremban II since September 2005.

STRATEGY

To dispose off non-core business units

Management is on the verge of disposing its non-core businesses, in a move to improve operational efficiency. By doing so, ROE is expected to improve tremendously going forward, as the non-performing/core assets will eventually be disposed off.

On 1 March 2006, Hai-O decided not to exercise the option for the secondary period of another two years from June 2006 to May 2008 upon expiry of the tenancy agreement, which ends at 31 May 2006, at UE3. This is expected to improve the group's bottom lines, resulting from saving in rental cost and advertising and promotion cost.

Besides, the group is also planning to shut down those non-performing retail stores and open more retail stores in other strategic locations, as part of its overall strategy to improve operational efficiencies.

PROFITABILITY

Robust earnings growth

Between FY02 and FY05, PBT grew at 3-year CAGR of 62.8% to RM10.3m, on the back of revenue CAGR of 18.5% during the said period. The robust earnings growth over the past few years was largely led by tremendous improvement in the operating margins in the MLM and manufacturing divisions.

PROFITABILITY TREND

FYE 30 Apr (RM'mil)	FY02	FY03	FY04	FY05
Revenue	83.8	89.0	119.5	139.3
Operating profit	4.1	4.2	6.7	10.7
PBT	2.4	3.5	6.4	10.3
Net profit	0.5	1.0	3.9	5.5
Operating margin	4.9%	4.7%	5.6%	7.7%
PBT margin	2.9%	3.9%	5.3%	7.4%
Net profit margin	0.6%	1.1%	3.3%	4.0%

Source: SBBSR

FINANCIALS

Strong financials

Cash ratio has improved to 0.56x in FY05 from 0.45x in FY02, while net cash position has increased to RM12.0m from a net debt of RM5.1m in FY02.

FINANCIAL STANDING

	FY02	FY03	FY04	FY05
Cash ratio (x)	0.45	0.69	0.52	0.56
Quick ratio (x)	1.27	1.47	1.27	1.27
Current ratio (x)	2.42	2.68	2.25	2.08
Net cash/(Net debt)/ (RM'mil)	(5.1)	7.9	7.2	12.0

Source: SBBSR

In view of the resilient earnings growth and minimal spending on capital expenditure, we expect Hai-O to remain in a net cash position going forward.

EARNINGS PROSPECTS

Capex insignificant

Hai-O's capital expenditure going forward is expected to be insignificant (approximately RM2.0m p.a. over the next two years) as bulk of the Research and Development (R&D) activities will continue to be conducted by the principals in China.

DPS to increase to 7-8sen going forward

Although the proposed share dividend would dilute Hai-O's future EPS, management has indicated that future dividend payout is expected to increase to 7-8sen. Supporting the dividend payout is the expected robust earnings growth and low capital expenditure plan.

Earnings to jump by 29.1% in FY06

For FY06, even though revenue is projected to increase by a slower pace of 6.2% to RM147.8m, PBT is anticipated to amplify by 29.1% to RM13.3m. The bigger jump in PBT would be led by overall improvement in profit margins, particularly from the wholesale, MLM and manufacturing divisions. On the other hand, the expected lower growth in revenue is mainly due to our anticipation on the reduction of sales contribution from its non-core businesses, which have already been disposed.

For FY07, we expect PBT to improve by 33.1% to RM17.7m as the group bears fruits from its continuing strategies in broadening and strengthening of branded product distributorship.

VALUATION & RECOMMENDATION

Trading at huge discount to Amway

At current share price of RM1.13/share, the stock is trading at CY06 PER of 7.4x, which is 60.8% lower than Amway's prospective CY06 EPS of 18.9x.

We advocate that Hai-O should trade at 50% discount to Amway's prospective CY06 PER of 19.2x, for the following reasons: -

- Hai-O's significantly smaller capitalisation;
- Hai-O's lower PBT margin and ROE;
- Hai-O's significantly lower market share; and
- Hai-O's lower gross dividend yield

Fair value = RM1.45/share

We fairly value Hai-O at RM1.45/share by attributing a target PER of 9.5x to our projected CY06 EPS of 15.2sen. Our fair value represents an upside of 28.3%.

COMPARISON TABLE

	Price RM	Mkt Cap RM'mil	CY06 EPS (sen)	CY06 PER (x)	P/NTA (x)	G.Yield	ROE	PBT margin
Hai-O	1.13	78.7	15.2	7.4	0.81	6.2%	6.7%	7.4%
Amway	6.40	1,052.1	33.8	18.9	5.08	7.8%	26.1%	14.5%
Average	-	-	-	18.9	5.08	7.8%	26.1%	14.5%

Source: SBBSR

Balance Sheet

FY 30 Apr (RM' mil)	2003	2004	2005F	2006F	2007F
Fixed Assets	47.6	49.8	48.3	47.9	47.5
Intangible Assets	0.5	0.6	0.5	0.3	0.3
Other Fixed Assets	2.9	4.0	4.4	5.2	5.2
Inventories	23.9	24.1	25.2	26.9	29.4
Receivables	12.2	16.6	20.1	21.1	23.1
Others	3.1	1.9	1.8	1.8	1.8
Cash	13.5	12.9	17.4	22.8	31.1
Total Assets	103.8	109.9	117.7	126.0	138.5
Payables	11.1	16.5	21.7	21.1	23.1
ST Borrowings	5.6	5.7	5.4	4.9	5.4
Other ST Liability	2.9	2.4	3.9	1.0	2.3
LT Borrowings	0.0	0.0	0.0	0.0	0.0
Other LT Liability	0.2	0.4	0.2	0.2	0.2
Minority Interest	3.9	4.3	4.6	5.1	5.7
Net Assets	**80.0**	**80.6**	**81.9**	**93.7**	**101.7**
Share Capital	65.6	65.7	65.8	69.1	69.1
Reserves	14.4	14.9	16.1	24.6	32.7
Shareholders' Funds	**80.0**	**80.6**	**81.9**	**93.7**	**101.7**

Cashflow Statement

FY 30 Apr (RM' mil)	2003	2004	2005F	2006F	2007F
PBT	3.5	6.4	10.3	13.1	17.4
Net Interest Paid	0.2	-0.1	-0.3	0.0	0.0
Depreciation	2.1	2.3	2.5	2.6	2.4
Associates	0.3	0.1	0.2	0.2	0.1
Jointly controlled entities	0.0	-0.1	-0.1	-0.4	-0.4
Chg In Working Capital	-2.8	-2.6	-1.9	-4.1	-2.6
Others	2.4	1.4	-1.8	0.0	-3.7
Operating Cashflow	**5.6**	**7.4**	**8.9**	**11.3**	**13.3**
Capex	-1.0	-4.0	-2.2	-2.0	-2.0
Others	-0.2	-0.9	2.5	0.0	0.0
Investing Cashflow	**-1.1**	**-4.9**	**0.3**	**-2.0**	**-2.0**
Chg In Debts	-9.9	0.2	-0.2	-0.5	0.5
Dividends Paid	-1.5	-1.9	-2.4	-3.5	-3.5
Share Issue	11.8	-1.3	-1.9	0.0	0.0
Other	-0.4	0.0	0.0	0.0	0.0
Financing Cashflow	**-0.1**	**-3.0**	**-4.5**	**-4.0**	**-3.0**
Net Cashflow	4.4	-0.5	4.6	5.4	8.3
Currency Translation Differ	0.0	0.0	0.0	0.0	0.0
Beginning Cash	8.9	13.3	12.8	17.4	22.8
Ending Cash	**13.3**	**12.8**	**17.4**	**22.8**	**31.1**
Free Cashflow	**4.5**	**2.5**	**9.1**	**9.3**	**11.3**

Source: SBBSR

Income Statement

FY 30 Apr (RM' mil)	2003	2004	2005F	2006F	2007F
Turnover	**89.0**	**119.5**	**139.3**	**147.8**	**161.9**
EBITDA	**6.3**	**9.0**	**13.2**	**15.8**	**19.9**
Depreciation	-2.1	-2.3	-2.5	-2.6	-2.4
Operating Profit	**4.2**	**6.7**	**10.7**	**13.2**	**17.5**
Interest & Other Income	0.0	0.0	0.0	0.0	0.0
Interest Expense	-0.4	-0.4	-0.4	-0.4	-0.4
Associate	-0.3	-0.1	-0.2	-0.2	-0.1
Jointly controlled entities	0.0	0.1	0.1	0.4	0.4
PBT	**3.5**	**6.4**	**10.3**	**13.1**	**17.4**
Taxation	-2.3	-2.2	-4.5	-3.9	-5.2
Minority Interest	-0.2	-0.3	-0.3	-0.5	-0.6
Net Profit	**1.0**	**3.9**	**5.5**	**8.7**	**11.6**

Financial Data & Ratios

FY 30 Apr (RM' mil)	2003	2004	2005F	2006F	2007F
Growth					
Turnover	6.2%	34.3%	16.6%	6.2%	9.5%
EBITDA	-0.9%	43.2%	47.2%	19.7%	26.1%
Operating Profit	2.5%	59.7%	59.4%	23.4%	32.6%
PBT	45.3%	83.7%	61.5%	26.6%	33.4%
Net Profit	86.3%	296.3%	41.7%	57.6%	33.4%
Profitability					
EBITDA	7.0%	7.5%	9.5%	10.7%	12.3%
Operating Profit	4.7%	5.6%	7.7%	8.9%	10.8%
PBT	3.9%	5.3%	7.4%	8.8%	10.8%
Net Profit	1.1%	3.3%	4.0%	5.9%	7.2%
Effective Tax Rate	67.0%	34.8%	43.8%	30.0%	30.0%
ROA	1.4%	3.9%	5.0%	7.2%	8.6%
ROE	1.2%	4.8%	6.7%	9.3%	11.4%
Dupont Analysis					
Net Margin	1.1%	3.3%	4.0%	5.9%	7.2%
Total Assets Turnover	0.86x	1.09x	1.18x	1.17x	1.17x
Financial Leverage Multipli	1.30x	1.36x	1.44x	1.35x	1.36x
ROE	1.2%	4.8%	6.7%	9.3%	11.4%
Leverage					
Total Debt/Total Asset	0.05x	0.05x	0.05x	0.04x	0.04x
Total Debt/Equity	0.07x	0.07x	0.07x	0.05x	0.05x
Net Cash (RM'mil)	7.9	7.2	12.0	17.9	25.7
Valuations					
EPS (sen)	1.4	5.6	7.9	12.5	16.6
GDPS (sen)	3.7	4.6	5.3	7.0	7.0
NTA (RM)	1.57	1.66	1.78	1.82	2.00
PER	80.2x	20.2x	14.3x	9.1x	6.8x
Gross Yield	3.3%	4.1%	4.7%	6.2%	6.2%
P/NTA	0.72x	0.68x	0.63x	0.62x	0.57x

Definition of Investment Ratings

Stocks ratings used in this report are defined as follows:

BUY	Share price expected to appreciate 10% or more over a 12-month period
HOLD	Share price expected to be between 0% and 10% over a 12-month period
SELL	Share price expected to depreciate over a 12-month period

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