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

Corporate Highlights

Briefing Note

21 December 2010

Hai-O Enterprise

Has MLM Division Bottomed Out?

Share Price	:	RM2.82
Fair Value	:	RM1.35
Recom	:	**Underperform** (Maintained)

Table 1 : Investment Statistics (HAIO; Code: 7668) **Bloomberg: HAIO MK**

FYE Apr	Revenue (RMm)	Net Profit (RMm)	EPS (sen)	Growth (%)	PER (x)	C. EPS * (sen)	P/NTA (x)	Net Gearing (x)	ROE (%)	GDY (%)
2010a	511.1	70.9	35.0	35.4	11.1	-	2.4	Net cash	38.7	6.2
2011f	247.5	27.2	13.4	-61.6	21.0	27.0	2.5	Net cash	13.1	3.2
2012f	240.2	27.5	13.6	1.0	20.8	28.0	2.7	Net cash	12.4	3.2
2013f	272.0	31.4	15.5	14.0	18.2	32.0	2.9	Net cash	13.3	3.7

Main Market Listing / Trustee Stock ** Consensus Based On IBES Estimates*

- **2QFY11 results review.** Aside from being affected by the amendment in the Direct Selling Act (DSA), Hai-O's MLM division was also affected by the weaker sales during the month of September, which is part Ramadhan and part Hari Raya, resulting in lower Hai-O's member productivitiy as approximately more than 90% of its members are Malays. However, we understand that sales were abnormally low, even for a Ramadhan month, a lot worse than previous Ramadhan months, which we believe is partially due to the continuation of the downtrend momentum as seen in previous months.

- **MLM division bottomed out?** We understand that moving forward, the MLM division will be on a better footing after Hai-O's internal restructuring undertaken in April 2010 as a result of the amendment in DSA. Management believes that 2Q11 represented the bottom for its MLM division and it expects sales to grow from hereon through various new strategies like new incentives for the members, new products, and emphasis on training. Previously, Hai-O's incentives include yearly trips to various countries around Europe once a member reaches a certain sales target. It is now introducing holiday trips to regional places such as Hong Kong and Australia, with a lower sales target requirement so that more members can achieve the target.

- **Indonesia MLM not doing so well.** Hai-O's Indonesian venture is currently still loss-making, although management does expect it to breakeven by April 2011 (end-FY11). We understand that it is now focusing on smaller towns such as Pekan Baru and Surabaya where it currently has one stockist each. Hai-O's initial target market was Jakarta, but Jakarta did not receive Hai-O's products well as the market was already saturated with similar products, i.e. water filters. We understand that the total CDF in Indonesia is currently ~300 members but only a small number of this are active.

- **Risks.** The risks include: 1) termination of supply agreements from its suppliers in China; 2) stronger-than-expected strengthening of US$; and (3) weaker-than-expected increase in consumer spending.

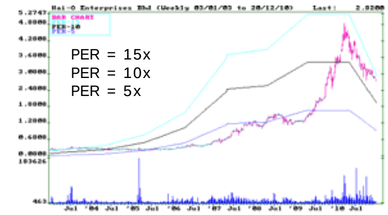
- **Forecasts.** After the changes in our revenue/member assumption, and also after imputing its energy division losses of RM2m, our FY11-13 earnings were reduced by 19.8-22.5% p.a..

- **Investment case.** After our earnings changes, our fair value is reduced to RM1.35 (from RM1.71 previously) based on unchanged 10x CY11 EPS. Maintain **Underperform.**

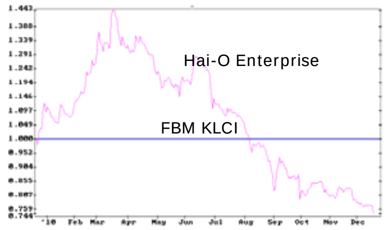
Issued Capital (m shares)	202.2
Market Cap (RMm)	570.2
Daily Trading Vol (m shs)	0.6
52wk Price Range (RM)	2.80-4.93
Major Shareholders:	**(%)**
Tan Family	30.0

FYE Apr	FY11	FY12	FY13
EPS chg (%)	(22.5)	(19.8)	(19.5)
Var to Cons (%)	(50.4)	(51.4)	(51.6)

PE Band Chart



Relative Performance To FBM KLCI



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- **2QFY11 results review.** Aside from being affected by the amendment in the Direct Selling Act (DSA), Hai-O's MLM division was also affected by the weaker sales during the month of September, which is part Ramadhan and part Hari Raya, resulting in lower Hai-O's member productivitiy as approximately more than 90% of its members are Malays. However, we understand that sales were abnormally low, even for a Ramadhan month, a lot worse than previous Ramadhan months, which we believe is partially due to the continuation of the downtrend momentum as seen in previous months. MLM sales during the months of August and October were better than September and within management expectatations. In terms of margins, we highlighted in our results note yesterday about the weaker MLM division margins in the 2Q of 13.2% (-6.8%-pt yoy), which we believe was due to the lower sales volume thus causing weaker economies of scale given the recurring fixed costs. Besides this factor, management also attributed the weaker margins to a sales discount given for its corset products of 15% during the period, as well as an incremental cost of roughly RM1m for donations that wasn't tax allowable.

- **MLM division bottomed out?** We understand that moving forward, the MLM division will be on a better footing after Hai-O's internal restructuring undertaken in April 2010 as a result of the amendment in DSA. The key restructuring move for its MLM division was a cap on the value of stock that members can purchase without getting a special approval, of RM20k, which will deter members from purchasing large amounts of stock in order to get promoted to Sales Manager (SM) quickly. Once a member gets Sales Manager status (after achieving a minimum RM20k worth of sales), he/she is able to enjoy a higher commission of 21% (vs. a normal 3% starting commission). As a result of this cap, Hai-O's MLM sales have been on a downtrend due to weaker membership growth and weaker revenue per member. Management believes that 2Q11 represented the bottom for its MLM division and it expects sales to grow from hereon through various new strategies like new incentives for the members, new products, and emphasis on training. Previously, Hai-O's incentives include yearly trips to various countries around Europe once a member reaches a certain sales target. It is now introducing holiday trips to regional places such as Hong Kong and Australia, with a lower sales target requirement so that more members can achieve the target. Hai-O is also introducing more products such as health food, to reduce dependence on its two core products i.e. the corset and water filter. The corset and water filter are high-ticket items priced at more than RM1k and is not easily sold by members, whereas the health food provides an easier selling platform that new members can start off with. Furthermore, for its new members, it will give more emphasis on sales training, so that the members are able to sell its products more effectively. We understand Hai-O's CDF is currently numbering at approximately 150k, with an average new member growth rate of 2000/mth, although average dropout among members is roughly the same number, thus resulting in no growth. Management expects that it will have roughly 120-130k members by end- FY11, which is higher than our projected 110k for FY11. Based on our estimates, annualised membership productivity was approximately RM7k/member for 1HFY11, which we believe will be roughly the same for the rest of FY11. We are leaving our CDF assumptions unchanged, although we downgrading our FY11-13 revenue/member assumption by 30% p.a. to be in line with 1HFY11 numbers.

- **Indonesia MLM not doing so well.** Hai-O's Indonesian venture is currently still loss-making, although management does expect it to breakeven by April 2011 (end-FY11). We understand that it is now focusing on smaller towns such as Pekan Baru and Surabaya where it currently has one stockist each. Hai-O's initial target market was Jakarta, but Jakarta did not receive Hai-O's products well as the market was already saturated with similar products, i.e. water filters. We understand that the total CDF in Indonesia is currently ~300 members but only a small number of this are active. The other issue faced by Hai-O in Indonesia was the too high price point of its products which are generally priced at a 10% premium vs. Malaysia to account for transportation costs etc. Given the lower average per capita wage in Indonesia vs. Malaysia, the higher price point did not sit well with potential customers, resulting in the anaemic membership and sales numbers. To combat this, Hai-O has since introduced new products with lower price points to attract members.

- **Energy division is as planned.** Hai-O is currently in the testing and assessment stages of its heat-transfer technology boilers. Currently it has manufactured and installed six boilers, all of which are currently being tested by a few rubber glove factories. We understand that after roughly seven months, the first installed boiler is still doing well at the factory that it has installed in. However, the energy division as a whole is still not expected to contribute to earnings in FY11 due to the long gestation period associated with industrial machinery. Nonetheless, assuming the product does gain commercial acceptance, we understand that it will be priced at approximately RM300k depending on the size, while management was not keen to reveal the kind of margins the boilers will be able to generate. As we are not certain when the boilers will meaningfully contribute to Hai-O's earnings, we are not imputing any assumptions with regards to its energy division. However, until the boilers are commercialised, this division is likely to continue recording losses of approximately RM2m per year (1HFY11: ~RM1m), which we are now imputing in our FY11-13 forecast.

Risks.

- The risks include: 1) termination of supply agreements from its suppliers in China; 2) stronger-than-expected strengthening in US$; and 3) weaker-than-expected increase in consumer spending.

Forecast and assumptions

- **Forecasts.** After the changes in our revenue/member assumption, and also after imputing its energy division losses of RM2m, our FY11-13 earnings were reduced by 19.8-22.5% p.a..

Recommendations

- **Investment case.** Although management has indicated that Hai-O's MLM division has bottomed out, we believe it will take a while for its membership drive to regain momentum and improve in terms of revenues and profitability. After our earnings changes, our fair value is reduced to RM1.35 (from RM1.71 previously) based on unchanged 10x CY11 EPS. Maintain **Underperform.**

Table 2. Earnings Forecasts

FYE Apr (RMm)	FY10a	FY11F	FY12F	FY13F
Turnover	**511.1**	**247.5**	**240.2**	**272.0**
Wholesale	43.9	46.1	48.4	50.8
MLM	418.1	150.1	138.1	165.1
Retail	41.8	44.3	46.7	49.2
Manufacturing	1.8	3.0	3.5	3.5
Other	5.6	4.0	3.5	3.5
Turnover growth (%)	17.4	(51.6)	(2.9)	13.2
Cost of Sales	(311.7)	(164.1)	(158.7)	(176.1)
Gross Profit	199.3	83.4	81.5	95.9
EBITDA	100.4	40.6	40.3	45.2
EBITDA margin (%)	19.6	16.4	16.8	16.6
Depreciation	(4.3)	(4.4)	(4.4)	(4.4)
Net Interest	(0.1)	1.1	1.5	1.9
Associates	0.0	0.0	0.0	0.0
Pretax Profit	**95.9**	**37.3**	**37.4**	**42.6**
Tax	(23.8)	(9.3)	(9.3)	(10.7)
Minorities	(1.3)	(0.7)	(0.5)	(0.6)
Net Profit	**70.9**	**27.2**	**27.5**	**31.4**

Table 3. Forecast Assumptions

FYE Apr	FY11F	FY12F	FY13F
Core distributor force (CDF)	110,000	86,000	98,000
Revenue per active member (RM/CDF)	7,172	7,244	7,317
Opening of new retail outlets	3	3	3
Revenue per outlet (RM'000)	643	649	656

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Stock Ratings

Outperform = The stock return is expected to exceed the FBM 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 FBM KLCI benchmark (+/- five percentage points) over the next 6-12 months.

Underperform = The stock return is expected to underperform the FBM KLCI benchmark by more than five percentage points over the next 6-12 months.

Industry/Sector Ratings

Overweight = Industry expected to outperform the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Neutral = Industry expected to perform in line with the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Underweight = Industry expected to underperform the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

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