OSK

**MALAYSIA EQUITY**
Investment Research
*Daily*

## Company Update

# Hai-O

## *Counting on Other Divisions*

**The Research Team**
+60 (3) 9207 7620
Research2@my.oskgroup.com

SELL

| | |
|---|---|
| **Target** | **RM1.61** |
| **Previous** | **RM1.61** |
| **Price** | **RM2.82** |

**CONSUMER**

Hai-O is involved in wholesaling, retailing, multi-level marketing and pharmaceuticals, and also operates modern Chinese medicinal clinics.

**Stock Statistics**

| | |
|---|---|
| Bloomberg Ticker | HAIO MK |
| Share Capital (m) | 202.2 |
| Market Cap (RMm) | 570.2 |
| 52 week H│L Price (RM) | 4.93│ 2.80 |
| 3mth Avg Vol ('000) | 449.5 |
| YTD Returns | -20.1 |
| Beta (x) | 0.65 |

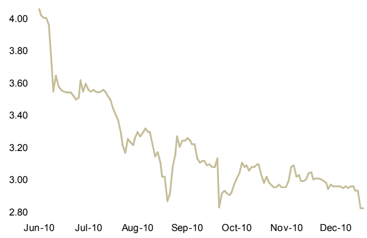
**Major Shareholders (%)**

| | |
|---|---|
| Tan Kai Hee | 9.62 |
| Akintan SB | 7.23 |
| Excellent Communications | 5.13 |

**Share Performance (%)**

| Month | Absolute | Relative |
|---|---|---|
| **1m** | -6.4 | -10.2 |
| **3m** | -8.5 | -14.1 |
| **6m** | -29.6 | -40.3 |
| **12m** | -3.3 | -25.6 |

**6-month Share Price Performance**




**At yesterday's briefing, Hai-O explained that its weak results were mainly due to stagnant net membership growth and the slower-than-expected recovery in member sentiment. The company has embarked on several strategies, including grooming Chinese distributors to sell lower value products, organizing more incentive trips and limiting the quantity new members can purchase, to bolster its MLM business. Management expects sales from other divisions to improve and to be able to reap sales from its technology division in FY11. Maintain SELL.**

**A weak 1HFY11.** To recap, Hai-O's 1HFY11 revenue and net profit sank 61.8% y-o-y to RM107.4m and 63.9% to RM13.9m respectively, mainly due to: (i) stagnant net membership growth, (ii) the tightening of personal loans approvals by banks, and (iii) the abnormally low sales in September, during which the slower sales during the Ramadhan month were further impacted by weak member sentiment. While gross margin for MLM was flat, EBIT margin dipped 2%-pts y-o-y, mainly due to the RM500k the company donated to charity and the lower new members' joining fee/members' renewal fee, as well as lower A&P subsidy income from suppliers. Note that the overhead expenses in the MLM division are somewhat fixed and do not go down proportionately even as sales decline. Management thinks that the company's results will bottom this year.

**More strategies to improve MLM business.** To bolster its MLM sales, other than requiring its members to declare the value of products they would be able to sell and introducing new products to reduce its reliance on key products, Hai-O will: (i) groom Chinese distributors to sell lower value products such as health food while its Bumiputera members will sell high value products like water filters and slimming sets, (ii) organize more incentive trips to neighboring countries such as Hong Kong and Australia based on lower sales targets to enable more members to participate in incentive trips, and (iii) limiting the purchase quantity of new members to prevent members from over-buying.

**Positive on other divisions.** The drop in MLM was partially buffered by wholesaling, retail and manufacturing sales, which recorded better y-o-y sales. Going forward, Hai-O intends to enhance profitability by introducing more in-house brands in its retail division and doubling its manufacturing capacity, which is currently fully utilized. As for its technology division, the trial run at some customers' manufacturing plants has been smooth and management is guiding for sales contribution to be felt possibly in FY11.

**Maintain SELL.** We maintain our FY11/12 earnings forecast at RM27.2m and RM32.2m respectively. TP is unchanged at RM1.61. While we believe that its retail, wholesaling and manufacturing sales will continue to grow going forward, we believe recovery on its MLM division would be slow given that this depends very much on the sentiment of its members.

| FYE Apr (RMm) | FY08 | FY09 | FY10 | FY11f | FY12f |
|---|---|---|---|---|---|
| Revenue | 373.8 | 435.2 | 511.1 | 205.2 | 236.6 |
| Net Profit | 48.5 | 52.3 | 70.9 | 27.2 | 32.1 |
| % chg y-o-y | 127.0 | 7.7 | 35.6 | -61.7 | 18.1 |
| Consensus | - | - | | 45.0 | 48.4 |
| EPS (sen) | 57.5 | 25.8 | 35.0 | 13.4 | 15.8 |
| DPS (sen) | 5.1 | 5.5 | 9.4 | 5.0 | 5.9 |
| Dividend yield (%) | 1.8 | 1.9 | 3.3 | 1.8 | 2.1 |
| ROE (%) | 34.5 | 31.6 | 33.9 | 12.0 | 13.2 |
| ROA (%) | 23.8 | 21.1 | 26.1 | 10.3 | 11.4 |
| PER (x) | 11.8 | 10.9 | 8.1 | 21.0 | 17.8 |
| BV/share (RM) | 0.69 | 0.82 | 1.03 | 1.12 | 1.20 |
| P/BV (x) | 4.1 | 3.5 | 2.7 | 2.5 | 2.4 |
| EV/ EBITDA (x) | 7.3 | 7.0 | 5.3 | 11.9 | 10.2 |

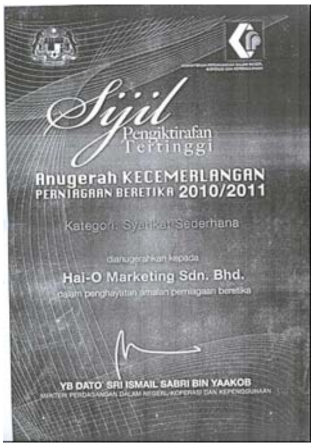
## KEY HIGHLIGHTS

**Weak results impacted by limp MLM division.** Last Friday, Hai-O released 1HFY11 results that were in line with our expectation. Its 1HFY11 revenue and net profit sagged 61.8% y-o-y to RM107.4m and 63.9% to RM13.9m respectively. Management attributed this mainly to the weak MLM division, which was hurt by: (i) stagnating net members growth/month, (ii) the tightening of personal loans approvals by banks, (iii) paltry sales of water filters, and (iv) the abnormally low sales in September, during which the slower sales during the Ramadhan month was further impacted by weak member sentiment although sales in August and October were up to expectation. While MLM gross margin was flat, EBIT margin dipped 2% pts y-o-y, mainly impacted by the RM500k the company donated to charity, as well as lower new members' joining fees or member renewal fees, and the lower A&P subsidy income from suppliers. Note that the MLM division's overhead expenses are somewhat fixed in nature and do not go down proportionately even as sales drop. Management thinks that the results will bottom this year.

**Number of registered members to fall.** YTD, the MLM division has a total of 150,000 members, but this is expected to fall further by year-end as the number of memberships expiring from the new addition of 5,000/month previously offsets the new monthly additions in the next few months.

**Hai-O granted 5-year licence.** Regardless of the poor performance since 4QFY10, Hai-O has been granted a 5-year licence and was named "most ethical company'' by the Domestic Trade, Cooperatives and Consumerism Ministry this year. This shows that the Government recognizes Hai-O's efforts in "cleaning" up its MLM division and that the company would continue to contribute towards promoting the local MLM industry. To recap, In April 2010, Hai-O decided to implement more stringent membership recruitment rules (such as requiring its members to declare the value of the products they would be able to sell, as well as terminated members found to have engaged in unethical practices) to prevent unhealthy practices such as the stocking up of products among some members, which was in line with the more stringent rules imposed by the relevant authorities.

**Figure 1: Most ethical company award**




*Source: Company, OSK*

**What are the strategies to revamp MLM?**

**Grooming Chinese members to sell lower value products.** While >90% of Hai-O's members are bumiputera, the group shifted some of its focus to Chinese distributors and is targeting to achieve at least 10% contribution to its revenue this financial year-end compared to less than 2% a year ago. These Chinese distributors are groomed to sell products such as health food. Hence, while Bumiputera members have easier access to loans to distribute higher value products, the Chinese members will handle products that Bumiputera members are less focused on.

**Launching more new products.** The group intends to launch more new products to reduce its reliance on key products. Recently, Hai-O launched a Biozone Food Purifer / Detoxifier and has sold more than 300 units since its launch in Oct 2010 as the product was pegged to an incentive scheme. Hai-O is targeting to sell 300-500 sets/month.

**Lower sales target for incentives trips; more training.** While members would have to achieve higher sales target to qualify for incentive trips as such trips were to countries farther away and hence were more expensive previously, Hai-O is now organizing more budget-oriented incentive trips to closer destinations such as Hong Kong and Australia that come with lower sales targets. This is to attract and motivate new members and make it easier for them to enjoy incentive trips. Other than this, instead of having a grand recognition ceremony for qualified members, the group will allocate the expenses for more training for its qualified members, which was a switch has been well-received by its members.

**Limiting new members' purchase quantity.** Since April 2010, Hai-O has capped the buying quantity of new members to avoid overbuying by members just to achieve a higher ranking and earn higher commissions. This measure could address the stocking up of products by members.

**How is Indonesia MLM performing?** As expected, its MLM operation in Indonesia is making slow progress due to the stiff competition and lower consumer purchasing power in that country. While the group's focus was in Jakarta previously, Hai-O has set up stockists in Pekan Baru and plans to set up a stockist in Surabaya as there is less competition in these towns. The group has obtained approvals for 6 to 7 products and has recruited 300 members YTD. Hai-O is targeting to break even by end-FY11.

**Update on other divisions**

**Weak 1HFY11 results buffered by the sales from other divisions.** The drop in its MLM 1HFY11 sales of 74.1% y-o-y was partially buffered by wholesaling, retail and manufacturing sales, which recorded y-o-y sales improvements of 17.1%, 3.9% and 5.4% respectively. Management is positive on all three divisions.

**Introducing more in-house products at retail outlets.** In 1HFY11, the retail division - which accounts for 18.1% of the sales pie - recorded 3.9% y-o-y sales growth. In fact, this division has been consistently recording positive sales growth since 4QFY10 and management intends to slowly increase the contribution of in-house products to 80% to improve its profitability. Retail EBIT margins grew from 5.1% in FY08, 7.3% in FY09, 9.8% in FY10 and 10.8% in FY11 as the group ramped up the contribution from in-house brands, which currently comprise 50%-60% of retail sales. Hai-O has 66 outlets YTD and 1 more is slated to open in FY11.

**Doubling manufacturing capacity.** The manufacturing division has also helped provide a buffer to the negative sales impact from MLM, albeit minimal. While this division accounts for <1% of total sales currently due to capacity constraint, we see it contributing more in 2012 onwards as Hai-O plans to spend capex of RM5m on the newly acquired factory. Upon the completion of the new plant in 1QCY12, the company's manufacturing capacity will double (50% of the capacity will cater to in-house use) and the group will produce over-the-counter (OTC) and food & beverage products apart from just healthcare products. We understand that manufacturing sales are quite resilient given that Hai-O will usually sign at least 1-year contracts with customers and the fact that the products have to be registered together with the name of manufacturer. If the customer changes its manufacturer, products will need to apply for approval again.

**Sales from technology division could be felt this year.** Hai-O has produced 6 broilers YTD and 5 broilers are on testing stage in potential customers' manufacturing plants while 1 will be used for demonstration purposes. So far, the testing has been running smooth and sales contribution could be felt as soon as this financial year. The estimated selling price ranges from RM300k to RM500k/unit depending on the size of the broiler. While there is no guidance on the margins, we note that the broiler could fetch high margins as the technology is owned by Hai-O and patents have been filed. The company can also realize some recurring income from the maintenance of the broilers. Hai-O plans to do a demonstration on the broilers in the middle of Jan next year. Note that the heat transfer technology that Hai-O invented could apply to many more applications involving heat transfer and need not be limited to broilers. We have yet to impute the contribution from this division.

**Maintain SELL.** We maintain our FY11 and FY12 earnings forecasts at RM27.2m and RM32.2m respectively and our TP is unchanged at RM1.61. While we believe that its retail, wholesaling and manufacturing sales will continue to grow going forward, we believe the recovery of Hai-O's MLM division would be slow given that this business hinges on member sentiment.

## EARNINGS FORECAST

| FYE Apr (RMm) | FY08 | FY09 | FY10 | FY11f | FY12f |
|---|---|---|---|---|---|
| Turnover | 373.8 | 435.2 | 511.1 | 205.2 | 236.6 |
| EBITDA | 69.5 | 77.0 | 97.3 | 41.6 | 48.7 |
| PBT | 67.7 | 75.9 | 95.9 | 37.6 | 44.1 |
| Net Profit | 48.5 | 52.3 | 70.9 | 27.2 | 32.1 |
| EPS (sen) | 57.5 | 25.8 | 35.0 | 13.4 | 15.8 |
| DPS (sen) | 5.1 | 5.5 | 9.4 | 5.0 | 5.9 |
| | | | | | |
| Margin | | | | | |
| EBITDA (%) | 18.6 | 17.7 | 19.0 | 20.3 | 20.6 |
| PBT (%) | 18.1 | 17.4 | 18.8 | 18.3 | 18.6 |
| Net Profit (%) | 13.0 | 12.0 | 13.9 | 13.2 | 13.6 |
| | | | | | |
| ROE (%) | 34.5 | 31.6 | 33.9 | 12.0 | 13.2 |
| ROA (%) | 23.8 | 21.1 | 26.1 | 10.3 | 11.4 |
| | | | | | |
| Balance Sheet | | | | | |
| Fixed Assets | 21.6 | 59.4 | 60.9 | 78.6 | 88.0 |
| Current Assets | 154.0 | 154.4 | 184.0 | 149.5 | 157.4 |
| Total Assets | 204.1 | 248.3 | 271.7 | 263.2 | 280.5 |
| Current Liabilities | 58.0 | 61.2 | 49.3 | 26.5 | 27.8 |
| Net Current Assets | 146.1 | 187.2 | 222.4 | 236.6 | 252.7 |
| LT Liabilities | 0.1 | 15.7 | 13.2 | 10.1 | 10.1 |
| Shareholders Funds | 140.6 | 165.4 | 209.2 | 226.6 | 242.6 |
| Net Gearing (%) | Net cash | Net cash | Net cash | Net cash | Net cash |

**OSK Research Guide to Investment Ratings**

| | |
|---|---|
| **Buy**: Share price may exceed 10% over the next 12 months | |
| **Trading Buy**: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain | |
| **Neutral**: Share price may fall within the range of +/- 10% over the next 12 months | |
| **Take Profit**: Target price has been attained. Look to accumulate at lower levels | |
| **Sell**: Share price may fall by more than 10% over the next 12 months | |
| **Not Rated (NR)**: Stock is not within regular research coverage | |

All research is based on material compiled from data considered to be reliable at the time of writing. However, information and opinions expressed will be subject to change at short notice, and no part of this report is to be construed as an offer or solicitation of an offer to transact any securities or financial instruments whether referred to herein or otherwise. We do not accept any liability directly or indirectly that may arise from investment decision-making based on this report. The company, its directors, officers, employees and/or connected persons may periodically hold an interest and/or underwriting commitments in the securities mentioned.

Distribution in Singapore

This research report produced by OSK Research Sdn Bhd is distributed in Singapore only to “Institutional Investors”, “Expert Investors” or “Accredited Investors” as defined in the Securities and Futures Act, CAP. 289 of Singapore. If you are not an “Institutional Investor”, “Expert Investor” or “Accredited Investor”, this research report is not intended for you and you should disregard this research report in its entirety. In respect of any matters arising from, or in connection with, this research report, you are to contact our Singapore Office, DMG & Partners Securities Pte Ltd (“DMG”).


Published and printed by :-

**OSK RESEARCH SDN. BHD. (206591-V)**
*(A wholly-owned subsidiary of OSK Investment Bank Berhad)*

Chris Eng

| Kuala Lumpur | Hong Kong | Singapore |
|---|---|---|
| **Malaysia Research Office**<br>OSK Research Sdn. Bhd.<br>6th Floor, Plaza OSK<br>Jalan Ampang<br>50450 Kuala Lumpur<br>Malaysia<br>Tel : +(60) 3 9207 7688<br>Fax : +(60) 3 2175 3202 | **Hong Kong Office**<br>OSK Securities<br>Hong Kong Ltd.<br>12th Floor,<br>World-Wide House<br>19 Des Voeux Road<br>Central, Hong Kong<br>Tel : +(852) 2525 1118<br>Fax : +(852) 2810 0908 | **Singapore Office**<br>DMG & Partners<br>Securities Pte. Ltd.<br>20 Raffles Place<br>#22-01 Ocean Towers<br>Singapore 048620<br>Tel : +(65) 6533 1818<br>Fax : +(65) 6532 6211 |

| Jakarta | Shanghai | Phnom Penh |
|---|---|---|
| **PT OSK Nusadana**<br>**Securities Indonesia**<br>Plaza CIMB Niaga,<br>14th Floor,<br>Jl. Jend. Sudirman Kav.25,<br>Jakarta Selatan 12920,<br>Indonesia.<br>Tel : (6221) 2598 6888<br>Fax : (6221) 2598 6777 | **Shanghai Office**<br>OSK (China) Investment<br>Advisory Co. Ltd.<br>Room 6506, Plaza 66<br>No.1266, West Nan Jing Road<br>200040 Shanghai<br>China<br>Tel : +(8621) 6288 9611<br>Fax : +(8621) 6288 9633 | **OSK Indochina Securities Limited**<br>No. 263, Ang Duong Street (St. 110),<br>Sangkat Wat Phnom, Khan Daun<br>Penh,<br>Phnom Penh, Cambodia.<br>Tel: (855) 2399 2833<br>Fax: (855) 2399 1822 |