

Eing Kar Mei
+60 (3) 9207 7620
karmeieing@my.oskgroup.com

Company Update

Hai-O

A Slow Recovery Seen

At yesterday's briefing for analysts, Hai-O explained that the 32.3% y-o-y drop in PBT for 4QFY10 was mainly due to slower member growth after the company imposed more stringent rules for membership recruitment and purchase order processing to prevent unethical practices among some members. As we believe its MLM division would continue to suffer in FY11 from these developments, we are cutting our FY11 and FY12 earnings further from RM74.6m and RM83.6m respectively to RM60.4m and RM66.5m. This further trims our TP to RM3.57 from RM4.42 previously.

4QFY10 results hit by slower member growth. To recap, Hai-O had reported weaker 4QFY10 results with revenue and PBT falling 25.6% and 32.3% y-o-y respectively. The 4QFY10 numbers were dragged down by its MLM division (accounting for 81.8% of total sales), which recorded a 35.5% y-o-y drop against the backdrop of slower member growth, which declined to an average 2000-3000 members/month from 4000-5000 members/month previously.

What caused the MLM slowdown. According to the management, member growth slowed down when the company decided in April to implement more stringent rules for membership recruitment to prevent unethical practices by some members. The tighter rules, including requiring members to declare the amount of the products they would be able to sell to their consumers, also affected buying sentiment. Based on management's experience, it would probably take some 6 months to recover. We are therefore forecasting a slight increase of the number of members but lower members productivity in FY11 given the more stringent rules, which translates into a ~20% contraction in our forecasted MLM sales.

Other divisions remain healthy. With more A&P activities and the introduction of more in-house brands, we believe wholesale and retail sales and profit would continue to be on an uptrend. Hai-O has allocated some RM5m in A&P for FY11. As for its technology division, the group is test running few applications for few industrial companies and expects the commercial products to hit the market in 2010. Hence, the sales contribution from this division could be felt sometime this year. Hai-O has filed 7 patents for this application YTD.

Maintain NEUTRAL. Despite the anticipated stronger growth and better margins from other divisions, we do not think its MLM division - which usually contributes >80% of total sales - would recover significantly in FY11. Hence, we are cutting our FY11 and FY12 earnings from RM74.6m and RM83.6m to RM60.4m and RM66.5m respectively. This reduces our TP to RM3.57 from RM4.42 previously.

NEUTRAL ↔

Target **RM3.57**
Previous **RM4.42**
Price **RM3.87**

CONSUMER (RETAIL)

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)	782.5
52 week H L Price (RM)	4.93 1.84
3mth Avg Vol ('000)	500.7
YTD Returns	9.7
Beta (x)	0.74

Major Shareholders (%)

Tan Kai Hee	9.61
Akintan SB	7.17
Excellent communication	5.13

Share Performance (%)

Month	Absolute	Relative
1m	-0.8	-5.0
3m	-13.2	-13.6
6m	17.9	5.2
12m	122.8	67.5

6-month Share Price Performance



FYE Apr (RMm)	FY08	FY09	FY10	FY11f	FY12f
Revenue	373.8	435.2	511.1	433.6	466.8
Net Profit	48.5	52.3	70.9	60.4	66.5
% chg y-o-y	127.0	7.7	35.6	-14.9	10.2
Consensus	-	-	-	-	-
EPS (sen)	57.5	25.8	35.0	29.8	32.8
DPS (sen)	16.7	17.5	21.8	15.0	17.0
Dividend yield (%)	4.3	4.5	5.6	3.9	4.4
ROE (%)	34.5	31.6	33.9	24.8	24.2
ROA (%)	23.8	21.1	26.1	20.9	20.7
PER (x)	16.2	15.0	11.1	13.0	11.8
BV/share (RM)	0.69	0.82	1.03	1.20	1.36
P/BV (x)	5.6	4.7	3.7	3.2	2.9
EV/ EBITDA (x)	10.3	9.8	7.5	8.3	7.4

KEY HIGHLIGHTS

4QFY10 results bore the brunt of slower members growth. To recap yesterday's report, Hai-O reported poorer 4QFY10 numbers as revenue and PBT plunged 25.6% and 32.3% y-o-y respectively while net profit fell at a smaller 9.8% y-o-y on a lower effective tax rate of 5% versus 31.9% in 4QFY09. While the retail division recorded higher revenue (+44.7% y-o-y) and profit, 4QFY10 results were dragged down by its MLM division (accounting for 81.8% of total sales), which recorded a 35.5% y-o-y drop amid slower member growth of an average of 2000-3000 members/month compared with 4000-5000 members/month previously. For illustration purposes, assuming that 50% of the new members contribute about RM10,000 /month to start up their business, a 3000 drop in new members recruited would pare down MLM sales by RM30m.

Why the slowdown? According to management, member growth faltered when it decided to implement more stringent membership recruitment rules in Apr 2010 to prevent unethical practices among some members, which was in line with the more stringent rules imposed by the relevant authorities. Apart from this, the tightening of the rules led to MLM leaders becoming more selective in recruiting new members, while stricter rules requiring members to declare the amount of the products they would be able to sell to consumers also somewhat dampened buying sentiment. Based on management's experience, it would probably take approximately 6 months to recover. Given that MLM is the group's revenue driver, Hai-O has set up a task force to beef up the performance of its MLM division. Going forward, the group would: (i) be more focused on members' productivity rather than an increase in numbers of members; (ii) diversify its products to reduce its dependence on products such as its water filters and slimming corsets. We understand that the group is launching some high margin products in 2H10. While the group has put in place measures to boost MLM sales, we believe this division would probably register a contraction in FY11 before recovering in FY12. We are forecasting a slight increase in the numbers of members but lower members productivity in FY11 given the tighter rules, which translate into a ~20% contraction in MLM sales.

How other divisions fared

Retail sales to continue to go up. Given the degree of A&P activities, the retail division - which contributes ~8% of group sales - has performed better than expected. Management is guiding for the group to add 4 to 5 outlets/year. This, coupled with the higher contribution from in-house brands, would shove retail sales and profit to a higher level. Given the higher contribution from its in-house brands, retail EBIT margin has expanded from 7.0% in 4QFY09 to 7.8% in FY10 and 13.9% in 4QFY09. On the other hand, the group is widening its wholesale markets by venturing into the pharmaceutical market. Again, with the introduction of more in-house brands, profits from the wholesale division should get a lift. Hai-O has allocated a total of RM5m for A&P for FY11

Good returns from technology division seen. Hai-O has successfully developed new technology which can be used in any application where heat is exchanged, transferred or dissipated. It can also be used in the conversion of heat to electricity. Maintenance cost would be much reduced due to its relatively simple physical construction. Apart from its existing collaboration with the Institute of Engineering Thermophysics of the Chinese Academy of Sciences (IET), the group is now conducting R&D with more parties such as China Aerospace Science and Technology Corporation (CASC) and local higher learning institutions. Hai-O has filed 7 patents for its applications YTD and will participate in the Shanghai expo and Internal Greentech & Eco Products exhibition and Conference Malaysia in the next few months. The group is also test running a few applications for some industrial companies and expects the commercial products to hit the market in 2010. Hence, sales contribution from this division may be felt as soon as this year.

Figure 1: Potential markets for the technology

- (1) Hot water boilers, pre-cool and pre-heat system, heat exchange
- (2) Energy saving anti-rust lamp posts, street lights, traffic lights, tower lights etc
- (3) Solar hear collector
- (4) Heat generator
- (5) Steam boilers for palm oil mills

Source : Hai-O presentation slides

Figure 2: Prototypes test run

- (1) Solar heat collector – test run in Beijing, China
- (2) Heat pipe steam boilers – few palm oil mills

Source : : Hai-O presentation slides

Figure 3: Collaboration with third parties

Date	
14 December 2009	Signing of agreement with Beijing Co-Chance Co Ltd, a company under the China Aero Space Corporation to develop a highly-efficiency system to harness solar energy
12 August 2009	Establishment of Joint Laboratory on “Innovative High Intensity Heat Transfer Technology” with the Institute of Engineering Thermophysics, Beijing
2 March 2009	Signing of Collaboration Agreement with Heet (M) SB to provide the latter with high efficiency heat transfer technology
29 March 2008	Signing of MOU with Seers International SB to develop an innovative heat pump in a hybrid hot water system

Source: Hai-O Energy brochure

Maintain NEUTRAL. Despite the anticipated stronger growth and better margins from other divisions, we do not think the group’s MLM division - which usually contributes >80% of total sales - would recover significantly in FY11. Hence, we are cutting our FY11 and FY12 earnings further from RM74.6m and RM83.6m to RM60.4m and RM66.5m respectively. Our TP is hence reduced to RM3.57 from RM4.42.

EARNINGS FORECAST

FYE Apr (RMm)	FY08	FY09	FY10	FY11f	FY12f
Turnover	373.8	435.2	511.1	433.6	466.8
EBIT	67.2	76.1	96.0	82.8	91.0
PBT	67.7	75.9	95.9	81.8	90.0
Net Profit	48.5	52.3	70.9	60.4	66.5
EPS (sen)	57.5	25.8	35.0	29.8	32.8
DPS (sen)	16.7	17.5	21.8	15.0	17.0
Margin					
EBIT(%)	18.0	17.5	18.8	19.1	19.5
PBT (%)	18.1	17.4	18.8	18.9	19.3
Net Profit (%)	13.0	12.0	13.9	13.9	14.3
ROE (%)	34.5	31.6	33.9	24.8	24.2
ROA (%)	23.8	21.1	26.1	20.9	20.7
Balance Sheet					
Fixed Assets	21.6	59.4	60.9	78.6	88.0
Current Assets	154.0	154.4	184.0	175.1	199.0
Total Assets	204.1	248.3	271.7	288.8	322.1
Current Liabilities	58.0	61.2	49.3	35.7	37.0
Net Current Assets	146.1	187.2	222.4	253.0	285.1
LT Liabilities	0.1	15.7	13.2	10.1	10.1
Shareholders Funds	140.6	165.4	209.2	243.0	275.0
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").

All Rights Reserved. No part of this publication may be used or re-produced without expressed permission from OSK Research.

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	Jakarta	Shanghai
Malaysia Research Office OSK Research Sdn. Bhd. 6 th Floor, Plaza OSK Jalan Ampang 50450 Kuala Lumpur Malaysia Tel : +(60) 3 9207 7688 Fax : +(60) 3 2175 3202	Hong Kong Office OSK Securities Hong Kong Ltd. 12 th Floor, World-Wide House 19 Des Voeux Road Central, Hong Kong Tel : +(852) 2525 1118 Fax : +(852) 2810 0908	Singapore Office DMG & Partners Securities Pte. Ltd. 20 Raffles Place #22-01 Ocean Towers Singapore 048620 Tel : +(65) 6533 1818 Fax : +(65) 6532 6211	Jakarta Office PT OSK Nusadana Securities Indonesia Plaza Lippo, 14 th Floor, Jln. Jend. Sudirman Kav 25, Jakarta 12920 Indonesia Tel : +(6221) 520 4599 Fax : +(6221) 520 4598	Shanghai Office OSK (China) Investment Advisory Co. Ltd. Room 6506, Plaza 66 No.1266, West Nan Jing Road 200040 Shanghai China Tel : +(8621) 6288 9611 Fax : +(8621) 6288 9633