

14 July 2020

Agriculture | Agriculture

Leong Hup International (LHIB MK)

Buy (Maintained)

NDR: The Cottage of Stability; Stay BUY

Target Price (Return): MYR1.18 (32.6%)
 Price: MYR0.89
 Market Cap: USD761m
 Avg Daily Turnover (MYR/USD): 3.41m/0.79m

- **Reiterate BUY with a higher DCF-derived TP of MYR1.18 from MYR0.88, 33% upside and c.1% yield.** We hosted a three days NDR for LHI and learned that poultry prices have rebounded sharply in key markets. The reduction in supply that propelled the price surge could sustain in Malaysia as the COVID-19 pandemic phases out financially thin farmers. Meanwhile, TBC received an encouraging response thanks to its value-for-money products and we believe it will be pivotal to mitigate the inherent poultry price volatility, hence warranting a valuation rerating.
- **Normalising demand outstrips a tight industry supply** and, as a result, poultry prices in key markets including Malaysia and Indonesia saw sharp rebounds (Figures 1 and 2). Consumption started to recover from May onwards as both countries eased their respective lockdown initiatives. Industry supply was unable to adjust accordingly, with smaller farmers struggling with finances and facing labour constraints. Moving forward, the tight supply situation in Malaysia may persist due to the COVID-19 crisis, a requirement of heavy capex to upgrade farms, and the lack of succession planning which could phase out the smaller-scale farmers.
- **The cottage of stability.** The downstream venture via The Baker's Cottage (TBC) is expected to mitigate the price volatility in poultry business hence warranting a valuation rerating. TBC presently takes up c.7% of Leong Hup International's (LHI) broiler supply in Malaysia and is projected to reach 30-40% once the store count is ramped up to 300 stores in 2023 from 57 stores currently. We are positive on the farm-to-plate model which allows TBC to price its roast chicken products competitively and believe TBC will prosper in the targeted suburban areas. There is also a potential for synergy as the attractive chicken products can drive footfall to stores and create cross-selling opportunities for its bakery products. Earnings contribution from TBC is likely to be immaterial in the near term as the company embarks on an aggressive expansion drive, estimated at +70 outlets per year.
- **We made no major changes to our earnings forecast post the non-deal roadshow (NDR).** The recovery in poultry prices is within our earlier expectation and TBC is not expected to chip in meaningfully to earnings. However, our DCF-derived TP rose to MYR1.18 from MYR0.88, after we lowered the risk premium to factor in TBC's valuation rerating. Our TP implies 20.7x P/E FY21F, which is in line with the regional peer average multiple (Figure 14). Essentially, we believe the favourable supply-demand dynamics represent a catalyst to share price and the sentiment on the stock should be further lifted by the rapid expansion of TBC.
- **Risks to our recommendation** include unfavourable changes in regulatory policies and supply-demand dynamics.

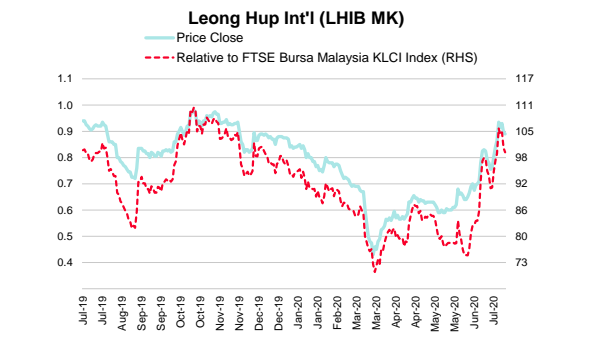
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Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	1.1	33.8	57.5	6.6	(5.3)
Relative	0.9	32.7	40.2	6.6	(0.1)
52-wk Price low/high (MYR)	0.43 – 0.98				



Source: Bloomberg

Forecasts and Valuation	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Total turnover (MYRm)	5,747	6,055	6,142	6,742	7,082
Recurring net profit (MYRm)	219	157	153	208	234
Recurring net profit growth (%)	18.4	(28.3)	(2.5)	35.8	12.3
Recurring P/E (x)	14.83	20.68	21.20	15.62	13.90
P/B (x)	2.5	2.0	1.9	1.7	1.6
P/CF (x)	9.30	4.95	6.53	6.96	5.60
Dividend Yield (%)	1.8	1.8	1.4	1.9	2.2
EV/EBITDA (x)	8.56	8.27	8.29	7.28	6.77
Return on average equity (%)	15.0	10.2	9.0	11.4	11.8
Net debt to equity (%)	108.3	74.2	71.7	72.4	70.6

Source: Company data, RHB

Note:

Small cap stocks are defined as companies with a market capitalization of less than USD1bn.

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Financial Exhibits

Asia	Financial summary (MYR)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Malaysia	Recurring EPS	0.06	0.04	0.04	0.06	0.06
Agriculture	DPS	0.02	0.02	0.01	0.02	0.02
Leong Hup International	BVPS	0.36	0.45	0.48	0.52	0.56
LHIB MK	Return on average equity (%)	15.0	10.2	9.0	11.4	11.8
Buy						
	Valuation metrics	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Valuation basis	Recurring P/E (x)	14.83	20.68	21.20	15.62	13.90
Discounted Cash Flow	P/B (x)	2.5	2.0	1.9	1.7	1.6
	FCF Yield (%)	(2.3)	7.8	4.5	2.1	4.0
Key drivers	Dividend Yield (%)	1.8	1.8	1.4	1.9	2.2
i. Regional expansion plan;	EV/EBITDA (x)	8.56	8.27	8.29	7.28	6.77
ii. Favourable product prices.	EV/EBIT (x)	12.24	12.67	13.18	11.25	10.47
	Income statement (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Key risks	Total turnover	5,747	6,055	6,142	6,742	7,082
i. Unfavourable change in regulatory policy;	Gross profit	953	1,004	1,007	1,118	1,193
ii. Unfavourable demand-supply dynamics.	EBITDA	655	651	652	759	827
	Depreciation and amortisation	(197)	(226)	(242)	(268)	(293)
	Operating profit	457	425	410	491	535
	Net interest	(109)	(137)	(124)	(127)	(130)
Company Profile	Pre-tax profit	349	289	286	365	405
LHI is on one of the largest fully-integrated producers of poultry, eggs, and livestock feeds in South-East Asia.	Taxation	(102)	(76)	(66)	(84)	(93)
	Reported net profit	186	151	153	208	234
	Recurring net profit	219	157	153	208	234
	Cash flow (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
	Change in working capital	(242)	39	(22)	(136)	(75)
	Cash flow from operations	349	657	497	467	580
	Capex	(423)	(404)	(350)	(400)	(450)
	Cash flow from investing activities	(379)	(373)	(350)	(400)	(450)
	Dividends paid	(66)	(84)	(46)	(62)	(70)
	Cash flow from financing activities	(7)	(3)	(152)	(90)	(200)
	Cash at beginning of period	502	459	765	760	738
	Net change in cash	(36)	281	(5)	(23)	(70)
	Ending balance cash	466	740	760	738	668
	Balance sheet (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
	Total cash and equivalents	459	765	760	738	668
	Tangible fixed assets	2,374	2,396	2,505	2,637	2,794
	Total investments	22	22	22	22	22
	Total assets	4,834	5,409	5,539	5,809	5,986
	Short-term debt	1,327	1,509	1,400	1,500	1,500
	Total long-term debt	1,044	873	1,000	1,000	1,000
	Total liabilities	3,069	3,229	3,251	3,377	3,390
	Total equity	1,765	2,181	2,287	2,433	2,596
	Total liabilities & equity	4,834	5,409	5,539	5,809	5,986
	Key metrics	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
	Revenue growth (%)	4.5	5.4	1.4	9.8	5.0
	Recurrent EPS growth (%)	18.4	(28.3)	(2.5)	35.8	12.3
	Gross margin (%)	16.6	16.6	16.4	16.6	16.8
	Operating EBITDA margin (%)	11.4	10.7	10.6	11.3	11.7
	Net profit margin (%)	3.2	2.5	2.5	3.1	3.3
	Dividend payout ratio (%)	31.2	38.5	29.9	29.9	29.9
	Capex/sales (%)	7.4	6.7	5.7	5.9	6.4
	Interest cover (x)	4.18	3.11	3.30	3.86	4.11

Source: Company data, RHB

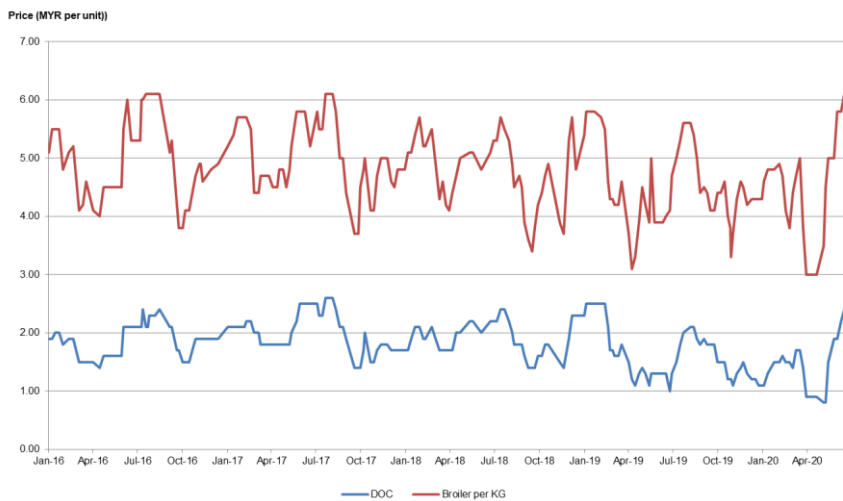
Poultry prices staging a sharp rebound

Poultry prices in key markets including Malaysia (27% of 1Q20 group revenue) and Indonesia (34%) saw sharp rebounds from the bottom reached in April. We believe this is a function of normalising demand outstripping short industry supply. The demand or consumption recovered from May onwards, as both countries eased their respective lockdown initiatives. However, industry supply was unable to adjust accordingly, with smaller farmers struggling with finances and facing labour constraints.

In Malaysia, the reduced supply may persist and can be structural, as the COVID-19 crisis could erode or undermine small farmers' financial strength. Hence, they will face an uphill challenge to upgrade their farm facilities to a closed house format, in order to comply with the conditions set out by Department of Veterinary Services (DVS) for a renewal of license. Besides, we understand that the lack of a succession plan may also phase out some of the smaller farms.

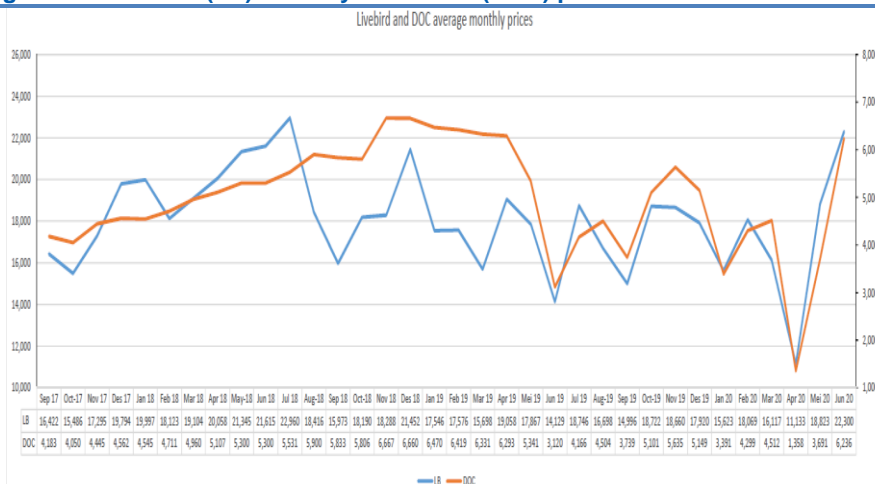
Barring the resurgence in COVID-19 cases, we believe the elevated poultry prices could sustain, given the supply-demand dynamics as discussed above. This will benefit enterprise farmers, with a larger business scale, such as LHI.

Figure 1: Broiler and Day-Old-Chick (DOC) price evolution in Malaysia



Source: DVS

Figure 2: Live Bird (LB) and Day-Old-Chick (DOC) price evolution in Indonesia



Source: Japfa

Synergistic farm-to-plate B2C model

In June 2020, LHI announced the acquisition of The Baker's Cottage from the founder family, for a total consideration of MYR20.3m. After an aggressive expansion drive throughout the first half of the year, currently there are 57 TBC outlets. Originally a brand known for its bakery products and moon cakes, TBC has gone through a business transformation following the introduction of roast chicken products, hence repositioning itself as a Quick Service Restaurant (QSR). The average capex to open an outlet ranges between MYR500-550k depending on the store size and management guided for a payback period of 3-4 years.

This synergistic acquisition will be essential to mitigating the inherent price volatility in LHI's incumbent poultry business. The farm-to-plate or B2C business model does away with the middleman in the supply chain and the resultant savings are shared between TBC and its customers. We understand that TBC now accounts for 7% of LHI's broiler supply in Malaysia and the figure is expected to reach 30-40% once the outlet count hits 300 in 2023. The unit is currently profitable but contributes insignificantly to the group's bottom line. However, the contribution should increase progressively and become a new earnings avenue for LHI if the expansion is executed as planned.

We visited several stores and observed good crowds queuing up for the roast chicken, particularly during the weekend, as the dine-in option is still not available at its outlets. The general feedback from our conversations with customers was positive, with most of them attracted by the competitive price point and decent product quality.

Figure 3: TBC outlet



Source: Company

Figure 4: TBC outlet



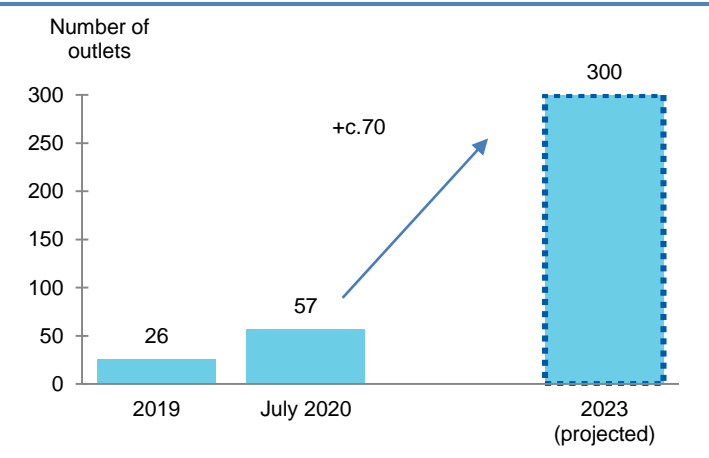
Source: Company

Figure 5: Large crowds during the Movement Control Order (MCO)



Source: Company

Figure 6: TBC outlet expansion plan



Source: RHB

Affordability is the name of the game

TBC's strategy revolves around affordability, offering value-for-money chicken meals in suburban areas with attractive pricing made possible by the farm-to-plate model. In addition, there is further synergy as the competitive price point of its chicken products attracts footfall to stores and creates cross-selling opportunities for its bakery products. We understand the average split between chicken and bakery products is c.35:65. We went to a few stores to check out the pricing and, unsurprisingly, TBC's roasted whole chicken price is 26-62% cheaper than the range of MYR14.90-MYR28.90 offered by its competitors.

Figure 7: TBC's roasted chicken promotion



Source: Company

Figure 8: TBC's set meal package



Source: Company

Figure 9: Competitor A's roasted chicken



Source: Company

Figure 10: Competitor A's set meal package



Source: Company

Figure 11: Competitor B's roasted chicken



Source: Company

Figure 12: Competitor C's roasted chicken



Source: Company

Figure 13: LHI's DCF valuation

FY Dec	FY21F	FY22F	FY23F	FY24F	FY25F	FY26F	FY27F	FY28F	FY29F	FY30F
EBIT	491	535	577	659	688	709	736	766	799	815
EBIT*(1-tax rate)	383	417	450	514	537	553	574	597	623	636
Add: D&A	268	293	320	349	378	410	445	480	517	558
Less: WC investments (WC Inv)	-136	-75	-88	-99	-108	-98	-114	-121	-132	-106
Less: Fixed investments (FC Inv)	-400	-450	-500	-500	-500	-600	-600	-600	-700	-700
FCFF	115	184	183	264	307	265	305	356	308	388
Discounted FCFF	108	161	150	202	220	178	191	209	169	199
Terminal value at T=10	8,088									
PV of terminal value	4,154									
NPV	1,788									
Less Debt	-1,640									
Equity Value of Firm	4,302									
Target Price (MYR)	1.18									
Implied FY21F P/E	20.7									

Rf	2.9%
Beta	1.2
Risk premium	7.7%
Rm	10.6%
TG (%)	2.0%
CoE	12.2%
CoD	5.2%
WACC	6.9%

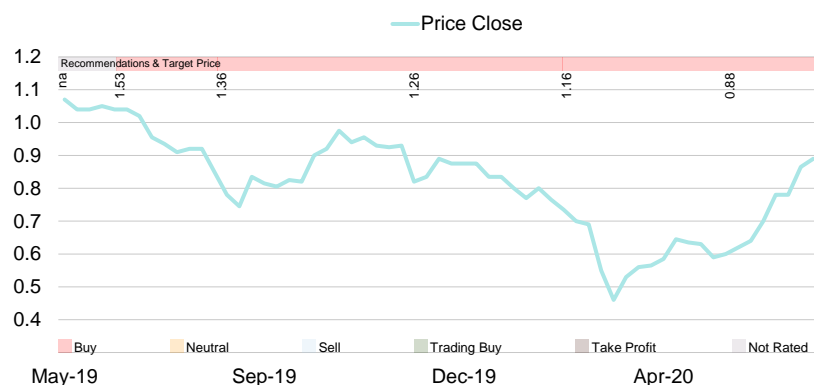
Source: RHB

Figure 14: Regional Peers

Company	FYE	Country	Price (Local Currency)	Mkt Cap (USDm)	PER (x)			Div. Yld (%)	ROE (%)	PBV (x)	EV/ EBITDA	NP Growth (%)		Rec
					Act ual	1 Yr Fwd	2 Yr Fwd					1 Yr Fwd	2 Yr Fwd	
San Miguel F&B	Dec	PH	69.10	8,259	24.5	28.5	25.1	2.5	15.6	4.3	11.3	-13.8	13.5	NR
CP Indon	Dec	ID	6000	6,805	26.5	34.9	23.5	1.5	13.4	4.3	20.0	-24.0	48.1	N
CP Food	Dec	TH	31.75	8,645	15.0	14.9	14.9	2.7	10.8	1.5	11.8	0.7	0.2	Buy
Masan Group	Dec	VN	56900	2,870	12.0	51.0	25.3	0.0	4.1	1.5	13.7	-76.5	101.2	NR
Japfa Comfeed	Dec	ID	1150	933	7.5	9.7	7.4	3.1	12.0	1.1	6.0	-22.8	30.9	Buy
Godrej Agrovet	Mar	SG	453	1,158	26.8	32.3	25.3	1.1	13.1	4.2	19.0	-17.1	27.9	NR
Japfa Ltd	Dec	SG	0.70	1,022	8.5	8.6	8.7	1.8	13.1	1.0	6.1	-0.5	-1.2	NR
Mkt. cap weighted average				29,897	19.5	27.0	20.7	2.0	12.3	3.0	13.6			

Source: Bloomberg, RHB

Recommendation Chart



Date	Recommendation	Target Price	Price
2020-05-20	Buy	0.88	0.59
2020-02-19	Buy	1.16	0.77
2019-11-27	Buy	1.26	0.86
2019-08-30	Buy	1.36	0.84
2019-06-18	Buy	1.53	1.07

Source: RHB, Bloomberg

Source: RHB, Bloomberg

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Trading Buy:	Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain
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