Consumer

Further Margin Squeeze Foreseen

Neutral

↔

By Soong Wei Siang l soongws@kenanga.com.my

We reiterate our NEUTRAL stance on the consumer sector as we expect the stronger sales driven by aggressive promotional and marketing activities to be offset by margin compression. We do not expect to see significant recovery in consumer sentiment as well as actual spending due to the inflationary pressure as well as negative perception in anticipation of GST implementation. We expect the retail space to be more affected by the soft consumer sentiments and lower consumer spending as consumers are likely to cut down their discretionary spending on the back of high living costs environment. Thus, we prefer the F&B subsector for its more resilient nature (necessity consumer products) vis-a-vis discretionary consumer products (retail and MLM subsectors). **As for the sin sector, we upgrade it to NEUTRAL from UNDERWEIGHT,** as we see greater value in the sector; (1) it could provide a relatively safe shelter for investors in weathering the market volatility, (2) dividend play with yields >5%, (3) better coming quarter foreseen in view of the festivities and pre-GST stocking up activities, and (4) the successful illegal trading clamp down efforts by the authorities.

Better for F&B, still tough for retailers. 7 out of 14 stocks under our coverage reported results below expectations. Interestingly, all of the underperformed stocks (AEON, AMWAY, ASIABRN, HAIO, PADINI, PARKSON, and ZHULIAN) were in the retail and MLM space while every single one of the F&B coverages posted results within expectations. The negative deviation was lower-than-expected YoY sales due to persistently weak consumer sentiments and compressed profit margins on the back of higher operating costs in relation to the higher marketing and promotional expenses.

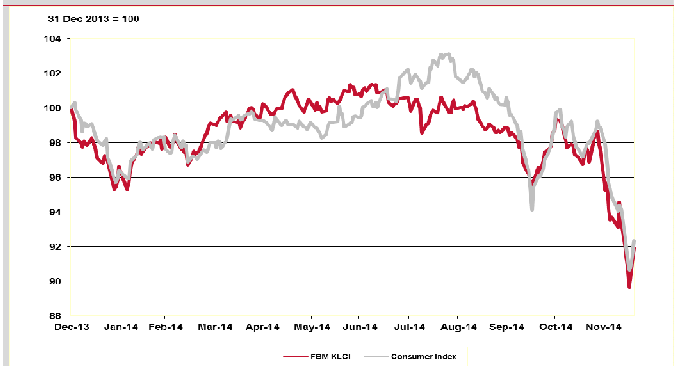
KLCSU slightly outperformed KLCI. As of our cut-off date (19^{th} Dec 2014), the KL Consumer Index (KLCSU) recorded YTD decline of 7.7%, which was slightly better than the performance of the KLCI (-8.1%). One of the top performers in the consumer index includes QL, which raked up impressive 18.4% YTD gain thanks to its robust earnings growth and favourable raw material prices; while BAT was also one of the big names which registered positive return during the period, at 4.3% probably due to the positive earnings results. On the flipside, GAB was the worst performer in the index with YTD decline of 18.2% as the Group has failed to maintain its stellar record of successive earnings growth in FY14 due to the higher operating costs and heightening threat from contrabands beers; while DLADY which was affected by higher operating costs and unfavourable forex, was down by 7.2% during the period under review.

Stronger sales on seasonality… Moving forward, we expect the stronger sales momentum sequentially to be sustained moving forward, supported by the marketing and promotional activities in conjunction with the year-end festivals as well as school holidays. With the latest reading of consumer sentiment index showing a slight decline to below 100-point level, we conservatively expect the consumer sentiment to stay subdued in view of the latest round of the subsidy rationalization program, which directly undermines the spending power of local consumers as a result of lower disposable income, as well as in view of the negative perception in anticipation of the GST implementation.

…but at thinner margin. In view of the aggressive marketing and promotional activities in coming quarters in conjunction with festivities and school holidays, we are expecting further margin compression, particularly in the retail space. Price discounts and promotions are widely expected to be given to consumers in order to boost sales as well as clearing off-season shipments on the back of the highly competitive retail market. Thus, we do not expect the net earnings growth to be in tandem with the top line growth judging from the anticipated higher advertising and promotional (A&P) and selling and distribution (S&D) expenses.

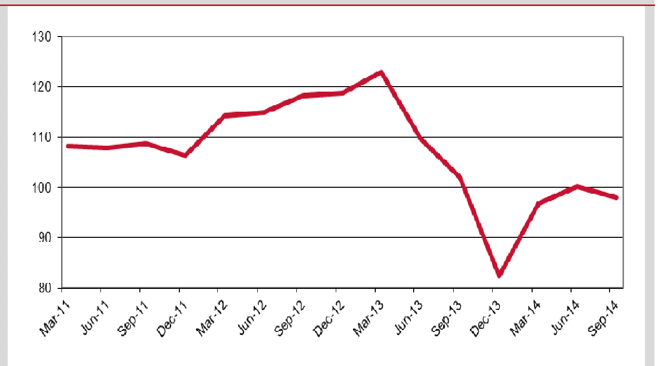
Not looking good economically. According to latest reading, private consumption rose slightly to 6.7% in 3Q14 from 6.5% in the previous quarter on normalizing prices. Moving forward, our economists are forecasting consumption to improve to 7.1% in 4Q14 on additional spending surrounding the year-end festivities and in early preparation for the GST. Meanwhile, for the Consumer Price Index (CPI), our in-house forecasts are guiding for 2015 CPI average of 4.0%, influenced by cost-push factors mainly due to the GST and the weaker ringgit but partly mitigated by lower oil prices. In a nutshell, the macro picture for 2015 is slightly more on the negative side for the consumer sector with 2015 private consumption foreseen to be lower at an average of 6.1% against 6.9% in 2014, further worsened by the higher inflation rate with CPI projected to be higher at 4.0% vis-à-vis 3.1% in 2014.

FBM KLCI VS KL Consumer Index



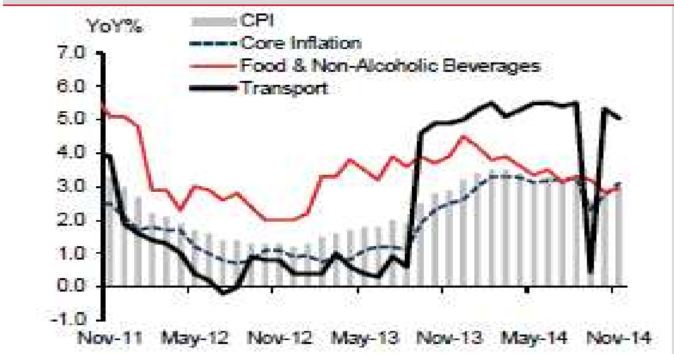
Source:Bloomberg, Kenanga Research

MIER Consumer Sentiment Index



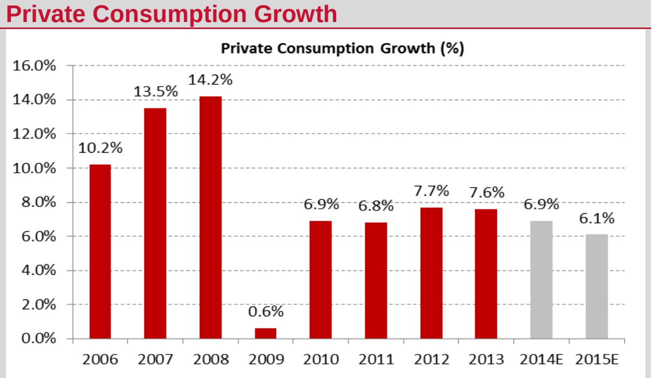
Source: MIER, Kenanga Research

Consumer Price Index



Source: Department of Statistics, Kenanga Research

Private Consumption Growth



Source: Department of Statistics, Kenanga Research

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Both our top pick of the sector were staple food counters in the F&B space, namely **QL (OP, TP:RM3.86)** for its sustainable earnings growth, supported by the robust demand of its surimi-based products exports and higher margin in the poultry segment with steady egg prices and lower feedstock costs; and **NESTLE (OP, TP: RM76.10)** as its new manufacturing plant is expected to drive earnings growth with additional capacity, and we also like its strong brand portfolio with entrenched market share.

As for the sin sector, we upgrade it to NEUTRAL from UNDERWEIGHT, as we see greater value in the sector; (1) it could provide a safe shelter for investors in weathering the market volatility, (2) dividend play with yields >5%, (3) better coming quarters foreseen in view of the festivities and pre-GST stocking up activities, and (4) the successful illegal trading clamp down efforts by the authorities.

For the brewers, we upgraded **GAB to MP from UP after raising its Target Price to RM13.56 (from RM12.88)** by ascribing a higher PER of 20x (from 19x), in line with -0.5SD 3-year mean, to its FY15E earnings following the sector upgrade. However, we **maintain both our call and TP for CARLSBG at MP, RM12.21** (18.5x PER FY15E, -0.5SD 3-year mean) as we stay conservative on our valuation to take the downside risk of tax dispute amounting to RM56m into account. Meanwhile, **BAT was upgraded to MP from UP after its TP was nudged higher to RM69.40 (from RM65.70)** correspondingly with the earnings upgrade post the latest round of price hike. The valuation remained unchanged at 20x PER FY15E, +0.5SD 5-year mean as we think the valuation premium is justified but sufficient enough to reflect its earnings growth potential as well as the dominant market share and larger market capitalization

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	Consumer Retail / MLM	Consumer F&B	Consumer SIN
Recent results	All 7 companies in the MLM and retail space reported disappointing results below expectations. The negative deviation was lower-than-expected YoY sales due to persistent weak consumer sentiments and higher operating costs in relation to the higher marketing and promotional expenses.	Out of 4 F&B companies under our coverage, all posted results within our expectation.	All 3 of the sin stock we cover reported earnings within our expectation.
Major trends	All retailers saw QoQ rise in sales revenue, probably due to the Hari Raya festival during the quarter. However, margins compressions capped the bottom line growth due to higher operating costs in regard to the operating expenses as well as marketing expenses in order to boost the sales. For the MLM companies, both HAIO and ZHULIAN experienced lower sales with the former affected by changes in product mix while the latter failed to see turnaround in key Thai market.	Most of the F&B companies experienced sales decline as compared to the previous quarter with the exception of the resilient QL, partly due to the fasting season in the quarter as well as persistent weak consumer sentiments on the back of higher living costs environment. OLDTOWN experience temporary setbacks in relation to delay in execution plans and certification issues which were all sorted out.	All sin stocks under coverage reported YoY growth in revenue, boosted by the increase in selling price in a greater extent than the organic growth of the sales volume. Net earnings also improved YoY on the back of better cost management.
Catalysts	Seasonality factors, year-end school holidays and festivities to drive up the sales. More aggressive promotional and marketing activities in conjunction with festivities to boost sales as well as to clear stocks.	Seasonality; school holidays and festivities to drive up demand for F&B products Lower raw material prices that would be able to lift earnings margins.	Better efforts from the authorities in tackling illicit cigarettes and contrabands beers. Seasonality; festivities to boost beers demand.
Risks	Lower margin in relation to the higher-than-expected A&P costs. Uncertainties in interest rate outlook, potential further subsidy reduction and the implementation of GST could potentially hamper consumer sentiment and consumer spending. Further subsidy rationalization program, which will put a dent on the consumer spending	Higher-than-expected import costs in relation to the unfavorable forex. Higher-than-expected raw material prices.	Excise duty hike, higher input cost and operating costs Stronger presence of illegal market.
Valuation basis	Between mean to +0.5SD over 3-5 years historical P/E.	Between mean to +1.5SD over 3-5 years historical P/E	Between -0.5 SD to +0.5 SD over 3-5 years historical P/E.
Dividend Analysis	At an average of 4.2%, with the MLM companies offering better yield ranging from 4.6%-5.8%. Padini from the retail space offers the highest yield at 6.5% due to the share price weakness.	DLADY offering best yield of 5.3% in F&B space with average of 3.8%, OLDTOWN also provide decent yield of 4.8%.	All offering yield >5% with average of 5.2% across the sector.

Valuation & Justification For Calls

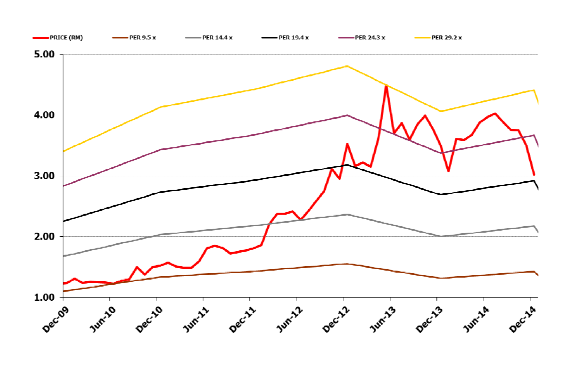
Company	New TP (RM)	New Calls	Previous valuation basis	New Valuation Basis	TP Revision (%)	Calls Action	Comments
Retail Sector							
AEON	3.10	UP	20.3x FY15 PER (which implies +0.5 SD over 5-year mean average)	20.3x FY15 PER (which implies +0.5 SD over 5-year mean average)	0.0%	Maintain	Maintain CALL and TP. Retail division remains challenging in view of the soft consumer sentiment which induced AEON to incur higher marketing expenses in order to stimulate the market. We remain negative on AEON's outlook as we do not expect the consumer spending to recover significantly judging by the soft sentiments amid higher cost of living environment.
AMWAY	11.42	MP	17.0x FY15 PER (which implies +0.5SD over 3-year mean average)	17.0x FY15 PER (which implies +0.5SD over 3-year mean average)	0.0%	Maintain	Maintain CALL and TP. The hike in transfer pricing is also expected to take a further toll on the profitability with the Group not prepared to increase its average selling price in FY14 with last price increase taking place in FY13. However, attributes such as dividend yield of 5.4% which is backed by its sturdy balance sheet as well as stable cash flows is expected to provide support to the share price.
ASIABRN	3.19	MP	9.5x FY15 PER (which implies +0.5SD over 3-year mean average)	8.8x FY15 PER (which implies 3-year mean average)	-7.3%	Maintain	Maintain CALL but lower TP. Downgraded the valuation to be in line with the PER mean to take the highly competitive retail market into consideration following the gradual establishment of well-known international brands. Sales could show improvement in the following quarters in view of the planned marketing and promotional activities to boost demand as well as reducing the inventory level. No catalyst foreseen at this juncture.
HAI-O	2.00	UP	12.6x FY15 PER (which implies 5-year mean average)	12.6x FY15 PER (which implies 5-year mean average)	0.0%	Maintain	Maintain CALL and TP. The MLM division will continue to suffer from the transition while the wholesale division is expected to see further margin compression in view of the unfavourable forex.
PADINI	1.78	OP (from MP)	12.6x FY15 PER (which implies +0.5SD over 5-year mean average)	12.6x FY15 PER (which implies +0.5SD over 5-year mean average)	0.0%	Upgrade	Upgrade CALL but maintain TP. Persistent weak consumer sentiments are expected to cause further margin compression as the Group embark on more aggressive promotional campaign to boost sales. However, recent share price weakness has presented a good entry opportunity as it is trading at only 10.5x PER FY15E (close to 5-year mean) and offers 6.5% dividend yield.
PARKSON	2.63	MP	SOP valuation	SOP valuation	0.0%	Maintain	Maintain CALL and TP. We expect Parkson to continue facing a tough operating environment on the back of weak consumer sentiment due to the economic slowdown, particularly in the China market, which contributes the crux of its earnings. Coupled with the intense competition from online shopping and oversupply of retail space, we believe it would take a longer-than-expected period of time for Parkson to reverse its SSSG's declining trend given that these stores have reached maturity.
ZHULIAN	2.00	UP	12.8x FY15 PER (which implies 3-year mean average)	12.8x FY15 PER (which implies 3-year mean average)	0.0%	Maintain	Maintain CALL and TP. Earnings continued to disappoint and thus the decline in share price. Moving forward, the recovery in the Thai market should see slight improvement following the election on July 2014 with the material effect to be reflected in the 4Q14 results. As for the local

							market, we foresee persistent weakness due to the poor consumer sentiment on the back of higher living cost environment. All in, we are negative on ZHULIAN.
F& B Sector							
DLADY	**44.22**	**MP (from UP)**	22.1x FY15 PER (implies +1.0SD over 5-years historical P/E)	22.1x FY15 PER (implies +1.0SD over 5-years historical P/E)	0.0%	Upgrade	Upgrade Call but maintain TP Recent results reflected the negative reaction by the consumer on price increase while lower milk prices failed to translate into higher profitability. Higher forex should mitigate the advantage in lower raw material prices moving forward but sales volume is expected to normalize with consumer adapt to the higher pricing environment. Share price retreated, providing ample upside to rating upgrade and dividend yield of 5.3% can support the share price.
NESTLE	**76.10**	**OP**	26.1x FY15 PER (implies +1.0SD over 5-years historical P/E))	26.1x FY15 PER (implies +1.0SD over 5-years historical P/E)	0.0%	Maintain	Maintain Call and TP Defensive and resilient in nature with consistent growth track record. We like the company for its ongoing expansion plan, aggressive marketing strategy and strong brand portfolio with entrenched market share. Completion of state-of-the-art Sri Muda RTD plant will double the current capacity and drive the earnings growth moving forward
OLDTOWN	**1.79**	**OP (from MP)**	14.1x FY16 PER (below 3-year mean PER)	14.1x FY16 PER (below 3-year mean PER)	0.0%	Upgrade	Upgrade Call but maintain TP Earnings should improve moving forward in view of the normalization of earnings in FMCG business and aggressive promotional campaign in café segments. Share price weakness as a result of selling by foreign shareholder; last updated foreign shareholding at 35%. Valuation appears to be attractive at 11.6x PER FY16E (below -0.5 SD 3-year mean) and 38% discount to sector average.
QL	**3.86**	**OP**	22.7x CY15 PER (implies +1.5SD over 5-year mean PER)	22.7x CY15 PER (implies +1.5SD over 5-year mean PER)	0.0%	Maintain	Maintain Call and TP Steady earnings growth supported by resilient and non-discretionary food products, which were minimally impacted by soft consumer sentiments. Robust demand on surimi-based product and higher margin in poultry-based product to drive earnings growth in near to mid-term while expansion plans (both organic and M&A) to drive longer term growth.
Sin Sector							
BAT	**69.40**	**MP (from UP)**	20x PER FY15E (implies +0.5SD over 5-year mean average)	20x PER FY15E (implies +0.5SD over 5-year mean average)	5.6%	Upgrade	Upgrade Call and TP. Earnings growth underpinned by the increase in selling price as well as better cost management despite lower foreseen sales volume. Better efforts in tackling illicits cigarettes could provide further earnings upside to the company.
CARLSBG	**12.21**	**MP (from UP)**	18.5x FY15 PER (-0.5SD over 3-year mean average)	18.5x FY15 PER (-0.5SD over 3-year mean average)	0.0%	Upgrade	Upgrade Call but maintain TP. Downside risk of tax dispute amounting to RM56m or 30% of FY14 earnings. Expected to see better earnings in near term due to seasonality and better illicit clamp-down efforts, further boosted by Singapore division on the back of successful stock rationalization program.
GAB	**13.56**	**MP (from UP)**	20x FY15 PER (-0.5SD 3-year mean average)	20x FY15 PER (-0.5SD 3-year mean average)	5.3%	Upgrade	Upgrade Call and TP. Earnings in the next 2 quarter should be strong in view of the festivities, continuous efforts of illicit clamp-down, as well as the possible stock-up activities pre-GST in 2Q15. Dividend yield at 5.3%.

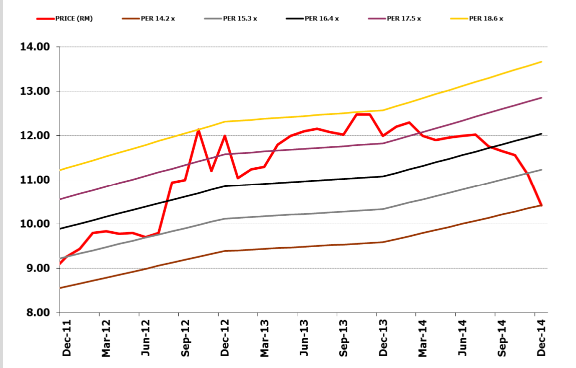
Source: Kenanga Research

Consumer stocks PER Bands

AEON

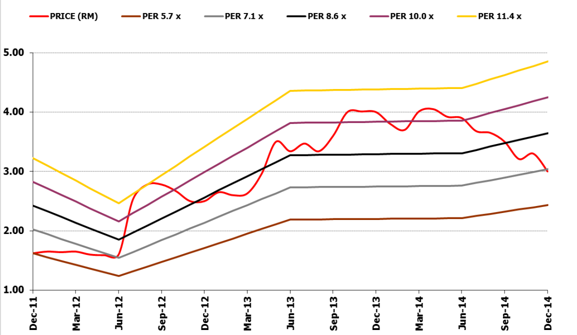


AMWAY

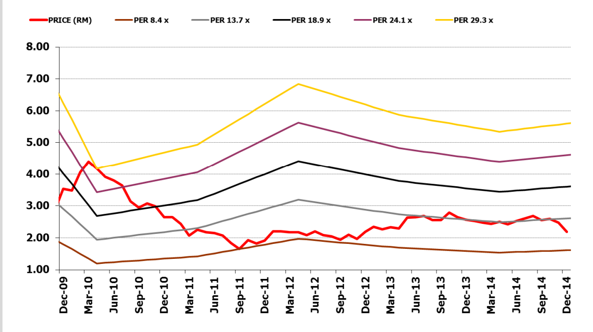


Source: Bloomberg, Kenanga Research

ASIABRN

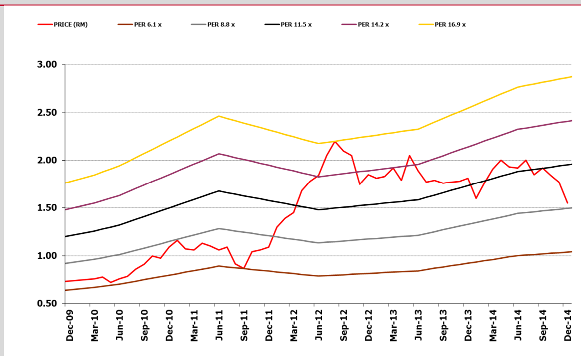


HAIO

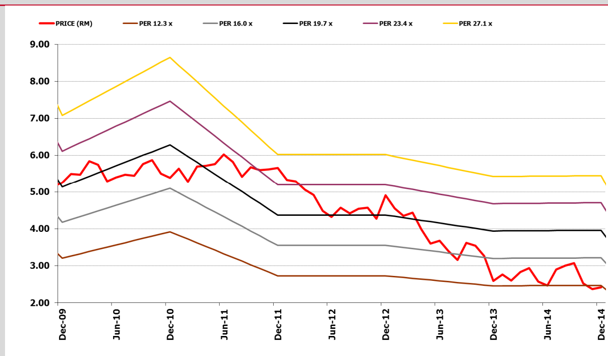


Source: Bloomberg, Kenanga Research

PADINI

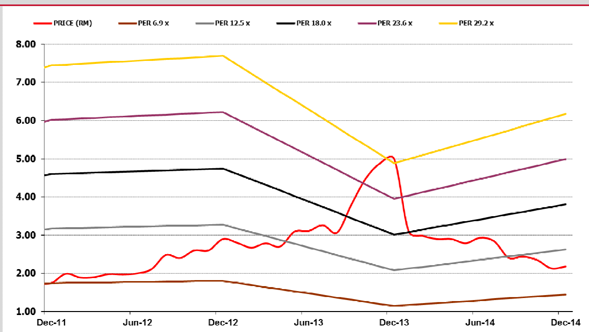


PARKSON

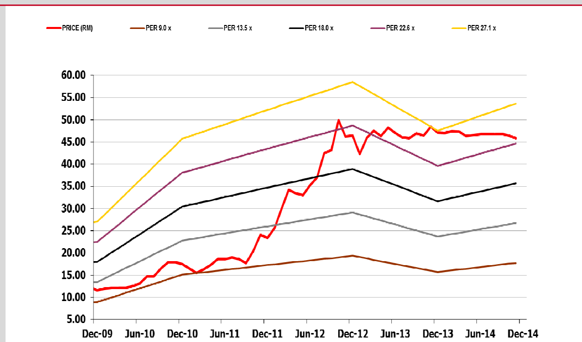


Source: Bloomberg, Kenanga Research

ZHULIAN

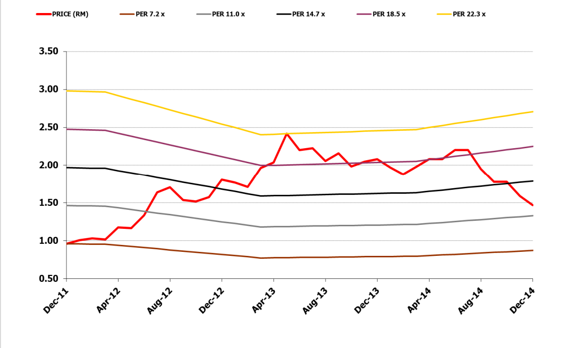


DLADY

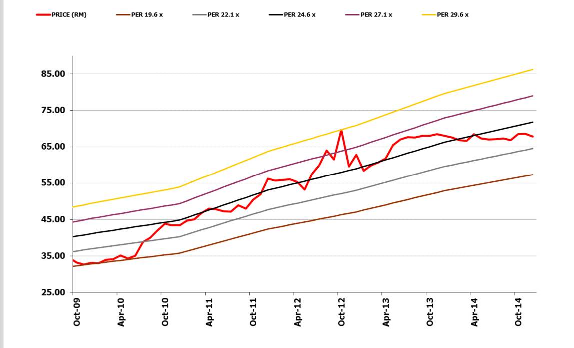


Source: Bloomberg, Kenanga Research

OLDTOWN

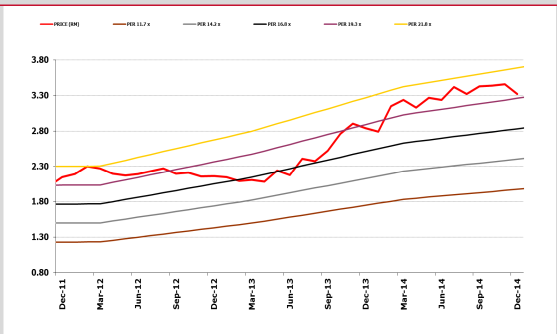


NESTLE

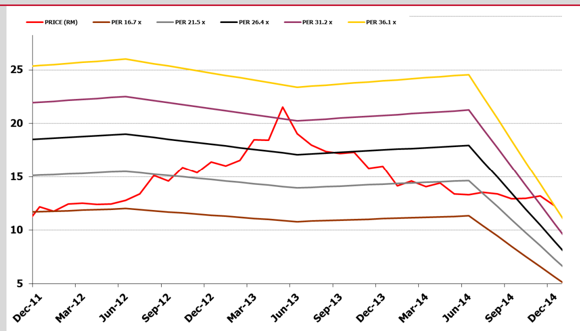


Source: Bloomberg, Kenanga Research

QL

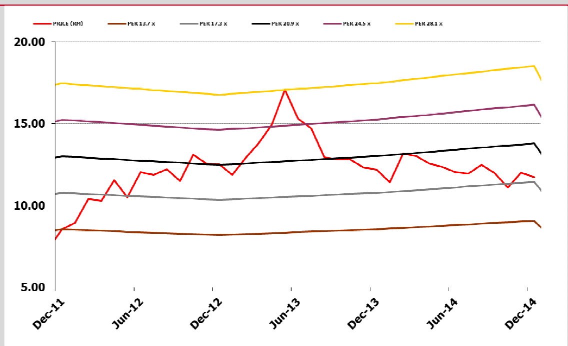


GAB

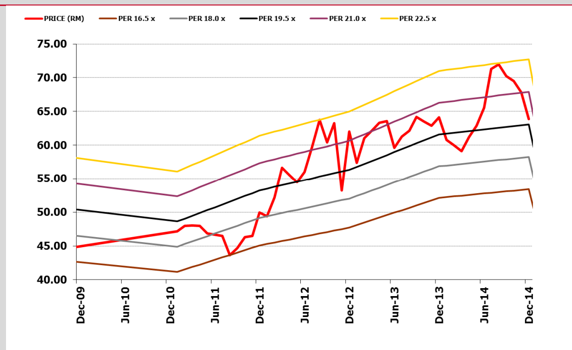


Source: Bloomberg, Kenanga Research

CARLSBG



BAT



Source: Bloomberg, Kenanga Research

Peer Comparison

NAME	Price	Mkt Cap	PER (x)			Est. Div. Yld.	Historical ROE	P/BV	Net Profit (RMm)			FY13/14E NP Growth	FY14/15E NP Growth	Target Price	Rating
	(RM)	(RMm)	FY12/13A	FY13/14E	FY14/15E			(x)	FY13/14A	FY14/15E	FY15/16E	(%)	(%)	(RM)	
CORE COVERAGE															
Consumer - Retail															
AEON CO (M) BHD	3.03	4,254.1	18.4	21.8	19.8	1.4%	14.2%	2.6	231.00	194.50	214.50	-15.8%	10.3%	3.10	Underperform
AMWAY (MALAYSIA) HLDGS BHD	10.42	1,712.9	15.7	16.8	15.5	5.8%	54.0%	7.3	109.00	102.20	110.40	-6.2%	8.0%	11.42	Market Perform
ASIA BRANDS	3.00	237.4	10.1	8.3	6.7	1.7%	16.0%	1.0	23.60	28.60	35.40	21.2%	23.8%	3.19	Market Perform
HAI-O ENTERPRISE BHD	2.19	427.6	11.0	14.7	13.8	6.4%	14.9%	1.7	40.50	30.10	32.30	-25.7%	7.3%	2.00	Underperform
PADINI HOLDINGS BERHAD	1.55	1,019.8	11.2	10.5	9.6	6.5%	21.3%	2.6	90.90	96.80	106.80	6.5%	10.3%	1.78	Outperform
PARKSON HOLDINGS BHD	2.42	2,569.4	14.4	14.7	13.8	3.2%	5.1%	1.0	184.30	180.50	192.30	-2.1%	6.5%	2.63	Market Perform
ZHULIAN	2.18	1,002.8	8.3	20.2	14.0	4.6%	10.1%	2.0	121.00	49.90	71.60	-58.8%	43.5%	2.00	Underperform
Average			12.7	15.3	13.3	4.2%	19.4%	1.9				-11.6%	15.7%		
Consumer - F&B															
DUTCH LADY	41.68	2,667.5	19.3	23.7	20.8	5.3%	67.5%	14.2	138.30	112.40	128.00	-18.7%	13.9%	44.22	Market Perform
NESTLE (M)	67.80	15,899.1	28.3	25.2	23.3	3.8%	70.8%	21.1	561.70	631.20	683.60	12.4%	8.3%	76.10	Outperform
OLDTOWN BHD	1.47	651.4	13.6	13.0	11.6	4.8%	N.A.	2.0	48.90	51.10	57.70	4.5%	12.9%	1.79	Outperform
QL RESOURCES BHD	3.32	4,143.5	25.9	21.8	19.3	1.3%	14.9%	3.2	159.90	189.90	215.20	18.8%	13.3%	3.86	Outperform
Average			21.8	20.9	18.7	3.8%	N.A.	8.8				4.2%	12.1%		
Consumer - Sin															
BRITISH AMERICAN TOBACCO BHD	63.88	18,239.7	22.1	19.5	18.4	5.1%	168.3%	35.5	823.40	934.70	990.60	13.5%	6.0%	69.40	Market Perform
CARLSBERG BREWERY MALAYSIA B	11.74	3,611.5	19.7	18.8	17.8	5.3%	102.6%	12.3	183.93	192.70	203.31	4.8%	5.5%	12.21	Market Perform
GUINNESS ANCHOR BHD	12.28	3,709.8	18.7	18.1	17.4	5.2%	54.9%	11.7	198.20	204.70	212.60	3.3%	3.9%	12.93	Market Perform
Average			20.18	18.80	17.88	5.2%	108.6%	19.8				7.2%	5.1%		

Source: Bloomberg, Kenanga Research

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10% (an approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%).
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of 3% to 10%.
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than 3% (an approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate).

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10% (an approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%).
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of 3% to 10%.
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than 3% (an approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate).

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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