

Heng Huat Resources Group Berhad

Initial Public Offering

SUBSCRIBE

IPO Price RM 0.45
Fair Value RM 0.51

Key Statistics

Bloomberg Ticker	HHR MK
Masa Ticker/Stock Code	Pending
Shares Issued (mil)	20.5
Market Capitalisation (mil)	92.6

Major Shareholders (%)

H'ng Choon Seng	35.5
Kee Swee Lai	26.4

Indicative Timetable

Prospectus Launch	30-June-14
Closing Date of Retail Offering	16-July-14
Balloting	18-July-14
Allotment	23-July-14
Listing @ACE Market	25-July-14

Analyst: Research Team
Email: research@interpac.com.my

Wealth from Waste

We are placing a fair value on Heng Huat with a subscribe recommendation and a 12-month target price of RM0.51. Our target price is derived from ascribing a 5.9XPER to Heng Huat's projected FY15 EPS of 8.6 sens. The price implies a 13% upside to the RM0.45 indicative retail tranche IPO price. Although we like the long-term biomass industry prospects, we believe the downside risks to Heng Huat's earnings will offset the brighter side of the story. Our projection for a higher sales volume will further erode margins due to the challenging business environment in the near term.

Investment Rationale: Company directors are substantial shareholders
Sizeable production capacity
Strong government support
Strong market share
Strong management leadership qualities

Investment Risk: Dependency on major customers
Stiff competition from other industry players
At the mercy of China's economy

Company Overview

Heng Huat Resources Group Bhd "Heng Huat", established in 2007, is an integrated manufacturer and trader of biomass materials. The company offers oil palm EFB fibre, coconut fibre and value-added products. Most of the EFB fibre is exported to China. Heng Huat recently expanded downstream by manufacturing and distributing mattresses and bedding accessories under brands of "Fibre Star" and "Xiong Mao"

Table 1: Earnings Forecast

FYE Dec	FY11	FY12	FY13	FY14(F)	FY15(F)
Revenue (m)	317.0	629.6	737.40	774.27	811.14
Pretax Profit (m)	137.1	136.2	113.82	109.21	156.36
Net Profit (m)	136.9	126.3	98.92	92.38	137.33
EPS (sen)	8.6	7.9	6.2	5.8	8.6
Pretax margin (%)	43.0	22.0	15.0	14.0	19.0
Net Profit margin (%)	43.0	20.0	13.0	12.0	17.0
PER (x)	5.2	5.6	7.2	7.7	5.9
DPS (sen)	NA	NA	NA	0.2	0.2
Dividend Yield (%)	NA	NA	NA	0.4	0.4

Objectives of the Issue

Table 2: IPO Utilisation

Proposed Utilisation	RM mil	%	Estimated Time Frame
Capital Expenditure	4.00	0.19	Within 36 months
Repayment of borrowings	9.38	0.45	Within 12 months
Working Capital	4.55	0.22	Within 12 months
Estimated listing expenses	3.00	0.14	Upon Listing
Total Gross Proceeds	20.93	1.00	

Source: Company prospectus, Inter-Pacific

The primary usage of the RM20.93 mil to be raised from the IPO would be utilised in:

Table 3: Breakdown of Repayment of borrowings

Repayment Description	RM mil
Acquisition of Plant 1 (EFB fibre production line)	3.78
Acquisition of Plant 4 (mattress production line)	1.84
Installation of 2 Briquette production line, 2012	2.84
Installation of 2 additional oil palm EFB Fibre production line	0.92
Total	9.38

Source: Company prospectus, Inter-Pacific

Table 4: Breakdown of Working Capital

Purpose	RM mil
Purchase of raw materials and defrayment of operational expenses	3.4
Defrayment of admin expenses	1.15
Total	4.55

Source: Company prospectus, Inter-Pacific

Table 5: Breakdown of CAPEX

Details	RM mil
Construction of new production facility	3.20
Refurbishment of Plant 1	0.80
Total	4.00

Source: Company prospectus, Inter-Pacific

Corporate Background

Heng Huat Resources Group Bhd's story began with the establishment of HK Fibre in 2007. Founded by Mr. H'ng Choon Seng and Mr. Kee Swee Lai, the company was initially engaged in the manufacturing and trading of coconut fibre and coconut peat.

In 2008, due to the limited supply of coconut husks for production expansion, the company diversified to the production of oil palm Empty Fruit Bunch (EFB) fibre.

In 2011, the company ventured downstream to undertake the manufacturing and distributing mattresses and bedding accessories through Fibre Star Reorganisation in May 2012. The Fibre Star Reorganisation relates to subsidiary Fibre Star acquiring HH Manufacturer's mattresses and manufacturing businesses, assets as well as the trademarks for product 'Fibre Star' and 'Xiong Mao' respectively.

In 2012, the company ventured into the manufacture and distribution of value-added oil palm EFB fibre product, namely Briquette, supplied mainly to local end users as an alternative fuel and charcoal.

To date, Heng Huat's EFB fibre is exported mainly to China, where it is used as raw material for the production of mattresses. Exports account for 55.2% of the Group's revenue in FY2013, whereby it has more than doubled from RM18.7mil to RM40.7mil between FY2011-FY2013. As a result, the company plans to extend its geographical footprint in China by the first quarter of 2015 as part of its expansion strategy.

As for the coconut fibre, the Group claims to be the first fully-integrated manufacturer of 100% natural coconut fibre mattresses in Malaysia. All these self-produced mattresses and other bedding accessories (cushion, pillow and bolster) are marketed under brand names "Fibre Star" and "Xiong Mao", distributed all over Malaysia.

Exhibit 1: Heng Huat's mattress and related product brands



Source: Company

Exhibit 2: Corporate Structure



* Balance 50% of shares are owned by the directors/shareholders of Arah Kawasan Sdn Bhd, their EFB supplier

Source: Company

Table 6: Principal Activities of Subsidiaries

Company	Principal Activities
Fibre Star	Manufacturing of mattresses and related products
Fibre Star Marketing	Marketing of mattresses and related products
HH Industries	Investment holding
HK Fibre	Manufacturing and trading of coconut biomass materials and value-added products
HK Kitaran	Manufacturing and trading of oil palm biomass materials and value-added products <i>-(EFB supply from oil palm plantations in Seberang Perai Selatan, Penang)</i>
HK Mega	Dormant
HK Palm Fibre	Manufacturing and trading of oil palm biomass materials <i>-(EFB supply from a palm oil miller, Arah Kawasan Sdn Bhd)</i>

Source: Company Prospectus, Inter-Pacific

Business Model

Biomass Division

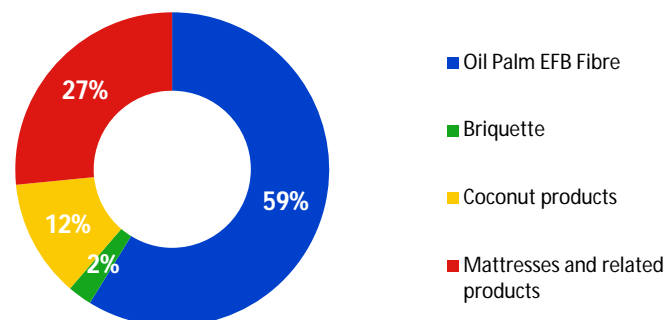
Oil Palm EFB is a waste by-product from crude palm oil mills. Heng Huat upon receiving these waste, converts them into environmentally friendly value-added products, such as Oil Palm EFB Fibre and Briquette. Through the process of de-fiberisation, the short fibres are filtered out to be used in the production of briquette. Both short and long fibres will then undergo intensive drying process to ensure the removal of moisture. In terms of application, biomass briquettes are biofuel substitutes that is utilised in industrial boilers, furnaces, kilns and for steam generation. Whereas, long fibres widely used in a variety of applications including mattress, geotextile, paper pulp, landscaping and horticulture.

As for the coconut husks, the process of sorting and drying is similar to oil palm EFB. The fibre extracted is processed into coconut fibre, otherwise known as Coir and coconut peats. Most of the Coir are retained in the Group for the production of mattresses while the peats are sold to customers for the purpose of fertigation and soil conditioning.

Mattress Division

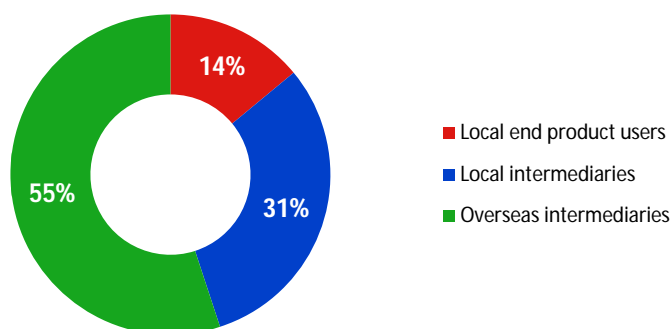
Heng Huat offers a wide range of mattresses and related products under the brand 'Fibre Star'. The company also produces related products such as pillow, bolster, cushion, cushion cover and mattress protector which are marketed under the brand 'Fibre Star' and 'Xiong Mao', as well as divan and headboard to complement 'Fibre Star' mattresses series. Currently, these mattresses and bedding accessories are distributed to furniture retailers in Malaysia. The company is also an OEM (Original Equipment Manufacturer) or contract manufacturer of fibre mattress for several local brands.

Table 6 : Breakdown of Revenue by Product (FY13)



Source: Company Prospectus, Inter-Pacific

Table 7: Breakdown of Revenue by Geographical location (FY13)



Source: Company Prospectus, Inter-Pacific

Approximately 55% of Heng Huat's sales are from overseas markets. Most of the exports are shipped to China, hence denominated in RMB. The bulk of the company's purchases is denominated in RM. Hence, there is little natural currency hedging. A strengthening of the Ringgit is generally negative for the group's sales as foreign receipts become less valuable. Nevertheless, we are not overly concerned over this issue as the company's revenue from FY12-13 were not adversely affected by foreign exchange fluctuations as RM generally moves in line with the RMB and is expected to do so for the remaining of FY14.

Industry Overview

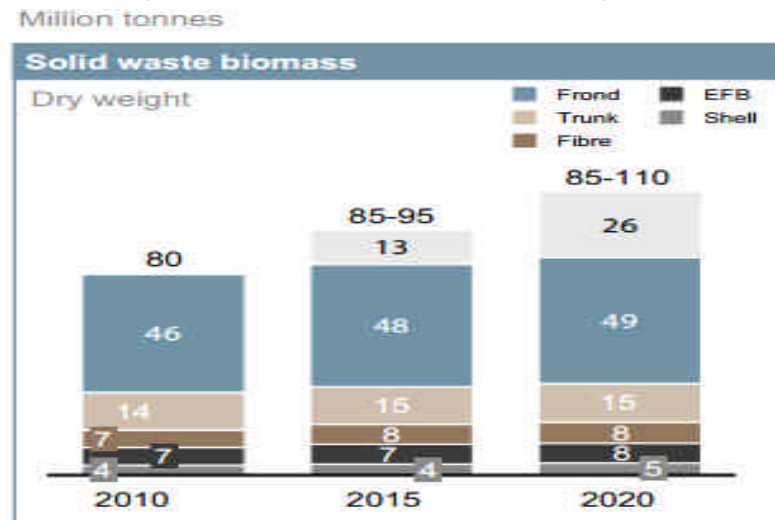
Malaysia is a country with a booming agriculture industry coupled with rich agro-biomass resources. The biomass industry was brought together by the utilisation of renewable organic substances including, palm oil waste, coconut fibre, sugar cane waste, rice husks, municipal waste and wood waste.

According to Forest Research Institute Malaysia (FRIM), it is estimated Malaysia generates in excess of 15,000 tonnes of solid agriculture waste per day. According to a separate article by Malaysian Palm Oil Board (MPOB), Malaysia's palm oil industry alone produced over 83mil tonnes of solid biomass per annum and this overall biomass figure is projected to rise to 85-110 mil tonnes by 2020.

As part of the Economic Transformation Programme (ETP), the Malaysian Government recognises the importance of such organic matter and created a platform, National Biomass Strategy 2020 (NBS 2020). The strategy acts as a forefront to mobilise the development and capitalisation of the new biomass-based industries by utilising

agriculture biomass for high-valued products. The Prime Minister launched the 1Malaysia Biomass Strategy delivery unit (1MBAS) in order to ensure the realisation of the aims of NBS2020.

Exhibit 3 : Projection of Solid waste biomass (tonnes) by FY2020



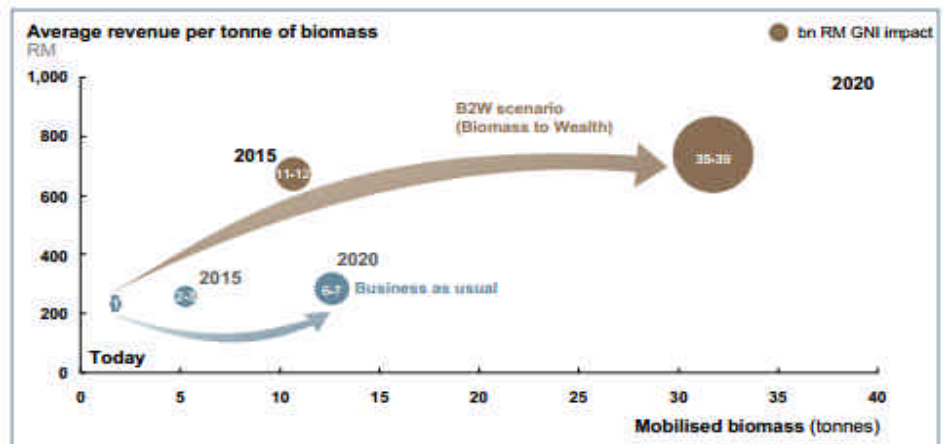
Source: Malaysian Innovation Agency

The NBS2020 is more focused on the oil palm biomass sector as it is the most important agriculture crop in Malaysia and it is the 4th largest contributor to the country's Gross National Income (GNI). Malaysia is currently the second largest producer and largest exporter of crude palm oil (CPO). CPO production improved by around 2.3% to 19.21 mt in 2013 from 18.79 mt recorded in 2012. The value of oil palm biomass alone amounted to an estimated 83mil dry tonnes in 2012. In tandem with the increase in CPO production, this is expected to climb to about 100mil dry tonnes by 2020.

Currently, an estimated three quarters of the oil palm biomass is returned to the field for nutrient replacement and mulching purposes in plantations. The remainder is used in animal feed, wood industry, power generation, etc.

According to the Malaysian Innovation Agency (MIA), oil palm biomass will steadily grow by about 1 mil tonnes p.a. for the portion used by the wood industry and 3.5 mil tonnes for use by the bio energy industries by 2015. Overall, the NBS2020 strategy is believed to deliver an incremental GNI of approximately RM30bil in revenue.

Exhibit 4: National Biomass Strategy 2020

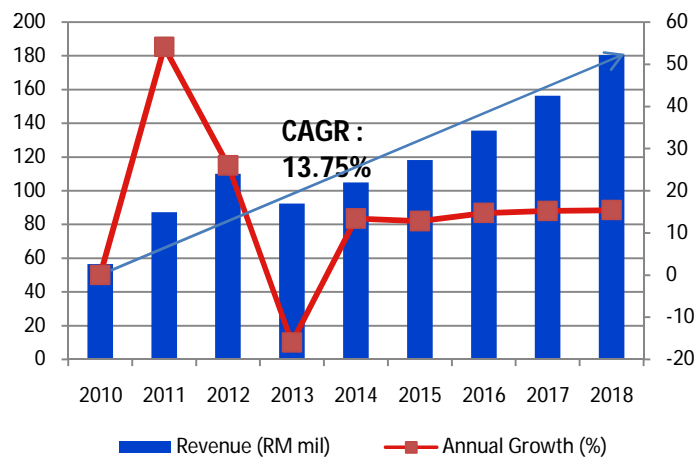


Source: Malaysian Innovation Agency

Therefore, the natural fibre made from coconut and oil palm biomass also increasingly benefited from the developments described above. Growth for this segment is diversified and robust as demand is favourable from both the local and international markets, especially China.

However, we note that Heng Huat's revenue suffered a small contraction during FY2013 due to softening prices for coconut fibre and the reduction of demand for oil palm fibres. Moving forward, this scenario is expected to recover as both type of fibres are expected to register healthy growth coming from the sluggish growth of China imports, population growth and growing applications of natural fibre.

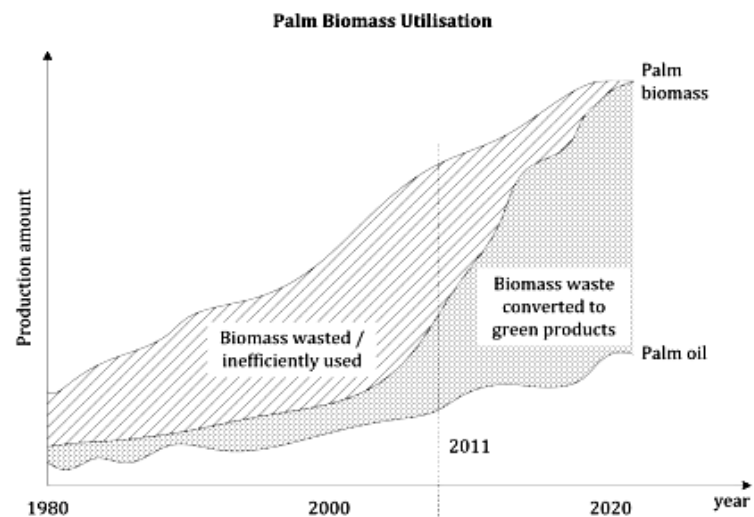
Chart 1: Historical, Estimated and Growth Forecast for Biomass materials market - Coconut & Oil Palm EFB Fibre, 2010-2018



Source: Company Prospectus, Inter-Pacific

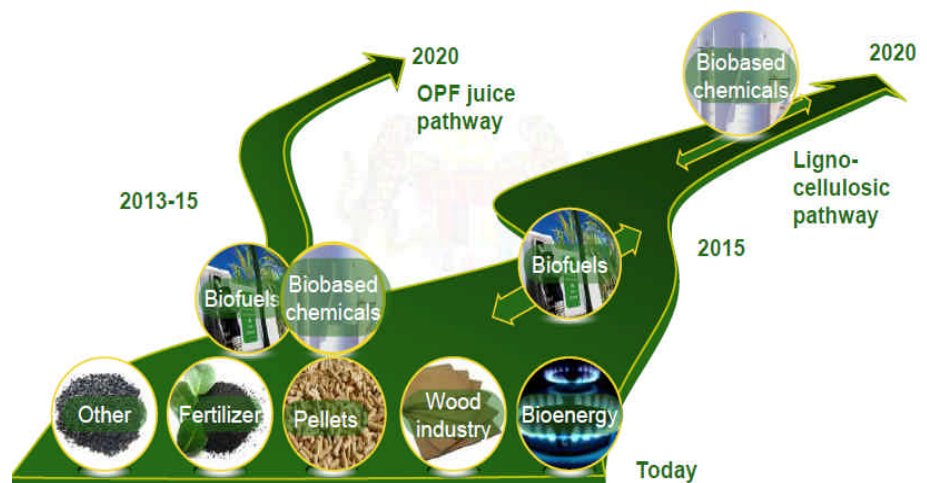
Conversely, according to the Journal of Cleaner Production (2012), the economic value of moderate value products such as dried long fibre and bio-briquette are predicted to decrease in the coming years. This is due to the overwhelming production of such products by millers and industrial players. The evolution of the biomass industry will be more inclined to value-added biochemicals, such as bioethanol to fulfill the needs of more profitable biomass conversion.

Exhibit 5: The Conceptual trend of palm biomass utilisation



Source: Malaysian Innovation Agency

Exhibit 6: Direction of Biomass industry to 2020



Source: Malaysian Innovation Agency

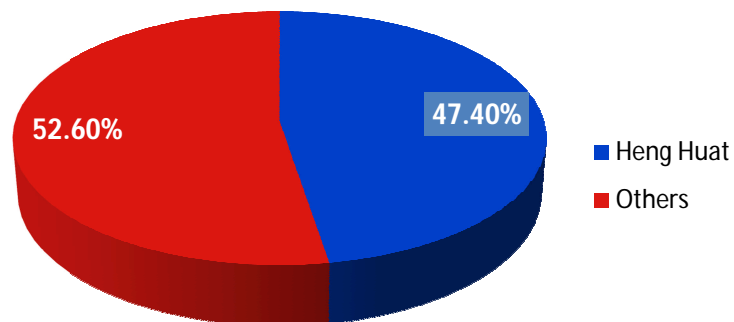
Investment Rationale

Company directors are substantial shareholders: Per IPO structure, Heng Huat's public offering will be approximately 29.7% of issued shares while 70.3% of shares are retained by the directors of Heng Huat. Mr. H'ng Choon Seng and Mr. Kee Swee Lai, both co-founders of Heng Huat, will collectively own 69.9% of shares in issue. We believe this is an indication that both of them are still keeping their pet close in their heart and are confident of Heng Huat's future prospects.

Sizeable Production Capacity: There is ample production capacity to meet growth in demand from both of its divisions. From FY2011 to FY2013, the utilisation rate for palm fibre production has increased from 51.7% to 74.1% while the coconut fibre production utilisation rate remains relatively stagnant averaging 55.2%. The coconut fibre sheet, briquette and mattresses segments are still relatively new to Heng Huat's business, hence the capacity utilisation rates have plenty of room for production growth. Furthermore, these production lines were custom-built by the company to enable large-scale production to meet growing demand.

Strong Market Share: Heng Huat's reported revenue of RM43.8mil in 2013 from the coconut and oil palm EFB fibre business, translates into a 47.4% share of the Malaysian biomass materials market for coconut and oil palm EFB fibres. We believe this condition will continue to be favourable to the company. Heng Huat will command a sizeable proportion of the pie even if there is a reduction of 10%-20% reduction in market share in the near term.

Chart 2: Heng Huat's share of the Coconut & Oil Palm EFB Fibre market (FY2013)



Source: Company Prospectus, Inter-Pacific

Strong Government Support: The biomass industry is backed by numerous government policies, namely National Biomass Strategy 2020 (NBS2020), National Green Technology Policy (NGTP), National Biotechnology Policy (NBP), and most importantly palm oil is one of the 12 National Key Economy Areas (NKEA) under the government's Economic Transformation Programme (ETP). With these initiatives from the Malaysian government, the biomass materials market will enjoy a steady flow of supply of EFB fibre. In addition, new biomass players are entitled to income tax exemptions of 100% of statutory income for a period of ten years from the Malaysian Investment Development Authority (MIDA). All these conditions will certainly benefit Heng Huat's net profit as a company operating in the biomass industry.

Helmed by Leading Light: Both co-founders, Mr. Hng and Mr Kee collectively have an average of 28 years' experience in the furniture and biomass materials industries, supported by key management and technical personnel from diverse backgrounds.

Investment Risks

Dependency on major customers: ShenZhen YueMao Imports & Exports Co.Ltd (ShenZhen YueMao) has been Heng Huat's major customer for the past 2 years, and accounted for 30.14% of the Group's total revenue in FY2013. The company claims that it has eight other China intermediaries which have been their customers for between 1 to as many as 5 years but we are not certain of how much each of these contribute to the overall earnings. Furthermore, it intends to set up a subsidiary company in China by the first quarter of 2015 to mitigate this risk. We believe it is still subjected to concentration risks with its limited number of corporate customers for the time being.

Stiff competition from other industry players: Heng Huat believes that their competitive edge is their capability to produce in quantities of value-added products at a competitive price. It prides itself on having custom-built production lines and its quality assurance compared to its competitors. Presently, there are over 30 market participants active in the coconut and oil palm EFB manufacture and oil palm mills. We believe competition will intensify as the biomass market offers growth opportunities and is sufficiently rewarding and enjoys support by the government.

At the mercy of China's economy: Based on the economic outlook from the Organisation for Economic Cooperation and Development (OECD) 2014, China's real GDP growth is expected to moderate around 7.7% from FY2014-FY2018 (compared to 10.5% from FY2000-FY2007), as the country rebalances its growth model towards growth driven by domestic consumption. This slowdown could weaken the growth momentum of Southeast Asian economies, as they have become more dependent on China as key trading partner. On the other hand, the Boston Consulting Group (BCG) forecasts that China's economy will continue to grow despite President Xi Jinping and other leaders' willingness to accept a slower growth pace now. For instance, the new one child plus policy will contribute to population growth, which will indirectly benefit Heng Huat's sales for mattresses. Regardless of how China performs, we believe the company's long term growth will fluctuate with changes in demand from China.

Table 7: Heng Huat's Future Developments

Description	Summary
Expansion of product offerings	Commercialisation of Geotextile production by Q4 2014
Enhancement of product offerings	Customisation of Briquette services to meet China demand
Expansion of Production Facility	Construction of approx. 80,000 sq ft production facility by Q3 2015
Green Power Generation Utilising Short Fibre	Installation of boiler turbine system to achieve zero waste by Q4 2015
Obtaining ISO Certificate for Subsidiary Companies	ISO Certification for HK Palm Fibre & Fibre Star for US & Europe market
Market Expansion	To incorporate subsidiary company in southern China by Q1 2015

Source: Company Prospectus, Inter-Pacific

Valuations

We are placing a fair value on Heng Huat with a subscribe recommendation and a 12-month target price of RM0.51. Our target price is derived from ascribing a 5.9X PER to Heng Huat's projected FY15 EPS of 8.6 sens. The price implies a 13% upside to the RM0.45 indicative retail tranche IPO price. Although we like the long-term prospects for biomass industry, we believe the downside risks to Heng Huat's earnings will offset the brighter side of the story. Our projection for higher sales volume will further erode margins due to the challenging business environment in the near term.

Ratings System

Ratings:	Description:
BUY	Total return is expected to exceed 15% in the next 12 months
NEUTRAL	Total return is expected to be between above -15% to 15% in the next 12 months
SELL	Total return is expected to be below -15% in the next 12 months

Abbreviation

Abbreviation	Definition	Abbreviation	Definition
PER	Price Earnings Ratio	CAGR	Compounded Annual Growth Rate
PEG	PER to Growth	CAPEX	Capital Expenditure
EPS	Earnings per Share	DPS	Dividend per Share
FYE	Financial Year End	ROA	Return on Asset
FY	Financial Year	ROE	Return on Equity
CY	Calendar Year	PBT	Profit Before Tax
MoM	Month-on-Month	PAT	Profit After Tax
QoQ	Quarter-on-Quarter	EV	Enterprise Value
YoY	Year-on-Year	EBIT	Earnings Before Interest And Tax
YTD	Year-to-Date	EBITDA	EBIT Depreciation & Amortisation
p.a.	Per Annum	WACC	Weighted Average Cost of Capital
DCF	Discounted Cash Flow	NTA	Net Tangible Asset
FCF	Free Cash Flow	BV	Book Value
NAV	Net Asset Value		

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Inter-Pacific Research Sdn Bhd (449005-X)
West Wing, Level 13,
Berjaya Times Square,
No.1, Jalan Imbi,
55100 Kuala Lumpur
General Line : 03-2117 1888 Fax : 03-2142 7678