

**INITIATION REPORT**

11 August 2017

<b>Name of PLC:</b> ELK-Desa Resources Bhd		<b>PLC Website:</b> www.elk-desa.com.my	
<b>Business Summary:</b> Involved in hire purchase financing for used motor vehicles, insurance agency business and furniture business			
<b>Top Two Shareholders:</b> Teoh Hock Chai @ Tew Hock Chai and deemed interest		30.18%	
Amity Corporation Sdn Bhd		6.58%	
<b>Market /Sector:</b>	Main Market /Finance	<b>Stock Code:</b>	5228
		<b>Bloomberg Ticker:</b>	ELK:MK
<b>Market Capitalisation:</b>	RM 276.63M	<b>Recommendation:</b>	HOLD
<b>Target Price:</b>	RM 1.17	<b>Expected Capital Gain:</b>	-
<b>Current Price:</b>	RM 1.19	<b>Expected Div Yield:</b>	5%
		<b>Expected Total Return:</b>	5%
<b>Analyst:</b> Teng Leong Nyeon / Tay Peng Keat   Tel : +603 2163 3200			
<b>Email:</b> lnteng@bcta.com.my / pktay@bcta.com.my			

Key Stock Statistics	2016	2017	2018F	2019F
Fully Diluted EPS (sen)	10.76	9.99	7.98	8.48
P/E (x)	11.16	12.01	15.03	14.16
Net Dividend/Share (sen)	6.75	6.75	6.00	6.00
NTA/Share (RM)	1.84	1.45	1.17	1.26
Book Value/Share (RM)	1.84	1.45	1.17	1.26
Issued Capital (mil shares)	174.65	230.30	300.14	300.14
52-weeks Share Price Range (RM)			1.12 - 1.26	
Estimated free float				60%
Average volume (shares)				188,000

Per Share Data	2016	2017	2018F	2019F
Year-end 31 March				
Book Value (RM)	1.84	1.45	1.17	1.26
Operating Cash Flow (sen)	5.73	(20.64)	4.76	6.24
EPS (sen)	10.76	9.99	7.98	8.48
Net Dividend/Share (sen)	6.75	6.75	6.00	6.00
Payout Ratio (%)	72.60	67.60	75.14	70.79
P/E (x)	11.16	12.01	15.03	14.16
P/Cash Flow (x)	20.95	(5.81)	25.22	19.23
P/Book Value (x)	0.65	0.83	1.02	0.96
Dividend Yield (%)	5.63	5.63	5.00	5.00
ROE (%)	6.47	7.02	7.06	6.98
Net Gearing (%)	n.c.	n.c.	n.c.	n.c.
<i>n.c. - net cash</i>				

P&L Analysis (RM mil)	2016	2017	2018F	2019F
Revenue	64.17	94.49	97.78	102.63
EBITDA	25.97	30.80	32.49	34.49
Depreciation	(0.45)	(0.58)	(0.58)	(0.60)
Net interest income	(0.20)	0.34	0.25	0.25
Pre-tax Profit	25.32	30.57	32.16	34.14
Net Profit	18.79	23.00	24.44	25.95
EBITDA Margin (%)	40.47	32.60	33.23	33.60
Pre-tax Margin (%)	39.47	32.35	32.89	33.26
Net-Margin (%)	29.28	24.34	25.00	25.28

**1. Investment Highlights/Summary**

- ELK-Desa Resources Bhd (ELKD) is a major independent hire purchase financier for motor vehicles. It is the market leader in the niche segment of entry-level small second-hand cars.
- ELKD is a well-run family-controlled company. Over the past 6 years since listing, the Company has registered healthy organic growth on the back of steady demand for its hire purchase loans and a favourable interest rate environment.
- The Company diversified into furniture business in 2015. The new division is profitable, but has yet to contribute significantly. Some of the family members have experience in this industry.
- The Company is conservatively managed, and emphasizes on quality rather than volume when growing its portfolio. Reflecting this, its NPL ratio for FY17 stood at 1.2%.
- Loans growth will continue to be supported by steady demand from its market segment. For now, growth is funded by shareholders' funds rather than debt. We believe this will continue for the foreseeable future. The Company is completing a 1:5 Rights Issue which will raise about RM60m. Equity investors are rewarded with above average dividend yield.
- We initiate coverage on ELKD with a **HOLD** call, with a fair value price of RM1.17 based on 1x FY18 P/BV. We note however that there is strong re-rating potential in the longer term.

**2. Company Background/Overview**

**a) History**

The Company began its corporate life as ELK-Desa Capital Sdn Bhd, a new subsidiary incorporated in 2004 by Unico Desa Plantations Bhd, a then Main Market-listed plantation company. The Company was incorporated for the purpose of venturing into hire purchase financing business together with Teoh Hock Chai @ Tew Hock Chai, the founder of Eng Lee Kredit Sdn Bhd. The business of Eng Lee Kredit Sdn Bhd, which was founded in 1971, was later folded into the new subsidiary.

The Company was subsequently spun off by its parent company and listed on 18 December 2012. ELKD now is majority owned by Teoh Hock Chai @ Tew Hock Chai.

**b) Board of Directors**

The Board of ELKD is helmed by Teoh Hock Chai @ Tew Hock Chai (Non-Independent Non-Executive Chairman) and there are four non-independent directors, three of which are his sons.

- Teoh Seng Hui (Group Executive Director)
- Teoh Seng Hee (Executive Director)
- Teoh Seng Kar (Non-Independent Non-Executive Director)
- Lim Keng Chin (Non-Independent Non-Executive Director)

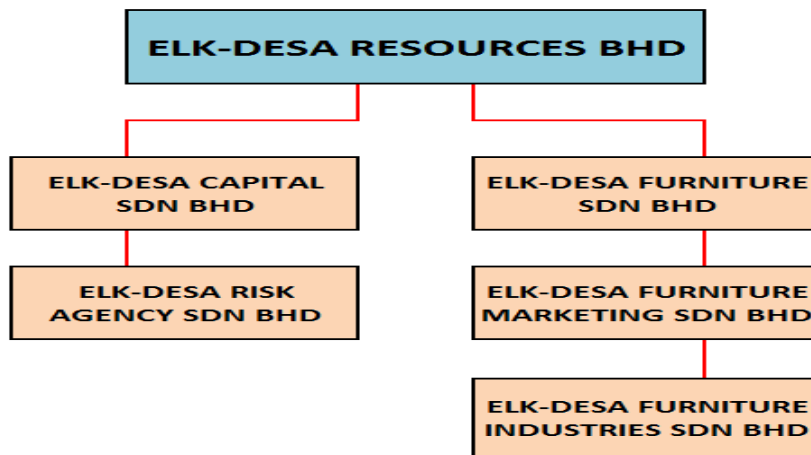
Four independent directors make up the rest of the Board members.

Teoh Hock Chai @ Tew Hock Chai and Lim Keng Chin are both industry veterans and are instrumental in growing ELKD into a leading used car financier.

**c) Corporate structure**

ELKD operates in two business segments targeted at the consumer market:

- Used car hire purchase financing & insurance agency
- Furniture



**Subsidiaries**

- ELK-Desa Capital Sdn Bhd
- ELK-Desa Risk Agency Sdn Bhd
- ELK-Desa Furniture Sdn Bhd
- ELK-Desa Furniture Marketing Sdn Bhd
- ELK-Desa Furniture Industries Sdn Bhd

**Principal Activity**

- Providing hire purchase financing for used motor vehicles
- Selling general insurance policies as an insurance agent
- Trading of furniture
- Wholesaling of furniture
- Manufacturing of furniture

### 3. Business Operations

#### a) **Hire Purchase (HP) & Insurance**

ELKD is one of the largest independent HP financiers for motor vehicles in Malaysia. Independent HP financiers refer to HP financiers that are not linked to any banking/financial institution or motor vehicle make/franchise holder. They principally provide HP financing in the secondary vehicle market.

ELKD has been involved in the used motor vehicle financing market since 2004. Within the market, it focuses on the niche segment of small value second-hand cars. In this particular segment, the Company is considered as the market leader with a hirer base of approx. 32,000 individuals. Currently ELKD operates its business out of two business locations, Kuala Lumpur and Klang which serve as loan processing and settlement branches for hirers.

The Company supplements the HP financing business by selling motor insurance policies to the hirers, plus offering loan protection insurance policy which covers accidental death, temporary or permanent disability and medical expenses. ELKD's insurance unit acts as an agency for Tokio Marine Insurans (Malaysia) Bhd and Berjaya Sompoo Insurance Bhd. The insurance agency claimed top agent spot in terms of premium production in Tokio Marine for 2016.

This segment represents the core business of ELKD, contributing 98% to the Company's earnings.

#### b) **Furniture**

Leveraging on the experience of some management personnel in the furniture business, the Company added this new business segment for earnings diversification. The new division commenced operations in July 2015. To further integrate the business, the furniture division started its wholesale and manufacturing activities in April 2016. The products are sold under in-house brand ELK-DeSA, and cater to the home furnishing segment.

Currently ELKD has four furniture retail showrooms, three in Klang and one in Shah Alam. The Company also distributes furniture products via a network of more than 400 furniture retail outlets in Malaysia and exports to countries like US, Australia, Singapore, etc.

This segment is still in its early stage of development, and contributed 31% and 2% to the overall revenue and earnings respectively.

### 4. HP Business Model & Strategies

#### a) **Business model**

- ELKD's earnings are derived from the net interest income between the effective interest rate charged to the hirers and its own cost of funds. The Company's primary source of funding is from shareholders' funds and financial institutions.
- ELKD does not engage in the marketing of its HP products but relies on a network of more than 1,000 motor dealers in Federal Territory and Selangor for referral of hirers. These motor dealers act as multiple sales points or marketing channels for the Company in these two states.
- Not having the need to market its products directly, ELKD's main operations duty is to perform credit assessment and management of its exposure to the credit risk of the hirers.
- Complementing its HP financing, ELKD also cross sells motor and loan protection insurance policies to hirers. This is a lucrative add-on to its main HP business.

**b) Business Strategies**

- Under-served Segment

ELKD's target market is the buyers of small value second-hand cars which broadly fall under:

- Vehicle engine capacity of 2,200 c.c. and below
- Age of vehicle between 6 to 15 years

The segment is considered an under-served segment as typically, it is not a priority area for financial institutions due to the low value of the loan size.

- High Margins

ELKD's customers are mainly from the low to medium income group, which is perceived to have higher credit risk profile. As the banks are reluctant to provide financing for this market segment, the Company is able to price in a higher spread. The default risk may not be as high as expected given that ELKD's customers are typically blue collar workers or self-employed, and utilise the vehicles for their practical transportation needs rather than as a lifestyle item.

- Risk Diversification

ELKD caps its HP financing amount to not more than RM20,000 per hirer to spread out the credit risk. Accordingly, there is no concentration risk in its HP portfolio, and the relatively small value also results in lower level of non-performing loan (NPL) for its overall portfolio. In FY17, ELKD had a hirer base of approximately 32,000 individuals while its average outstanding net HP receivables per hirer stood at RM11,000. NPL ratio was at a very manageable 1.2%.

- Strategic Location

Geographically, the Company only focuses its resources on two states which are densely populated in terms of motor vehicle population, i.e. Federal Territory and Selangor. These two states account for about 42% of the total Malaysian car population and offer a sizable pool of used cars for potential HP financing.

- Minimal Downside

Other factors such as model, resale value, low depreciation and maintenance profile are considered before offering financing. These selective financing criteria provide ELKD with a minimal downside in the event of default, as the vehicles can be sold off once repossessed. Also, ELKD will not offer financing for continental makes due to the perceived high maintenance charges.

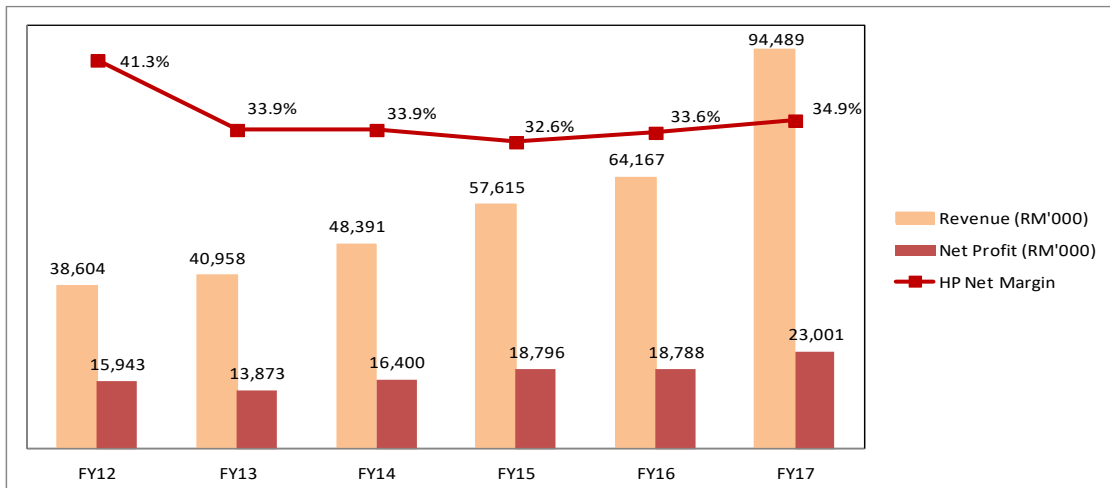
- Widen Motor Dealer Network

ELKD strives to increase its corporate visibility/brand awareness through the growth of its motor dealer network, while maintaining close relationship with existing dealers.

5. Financial Review

a) **Revenue & Net Profit**

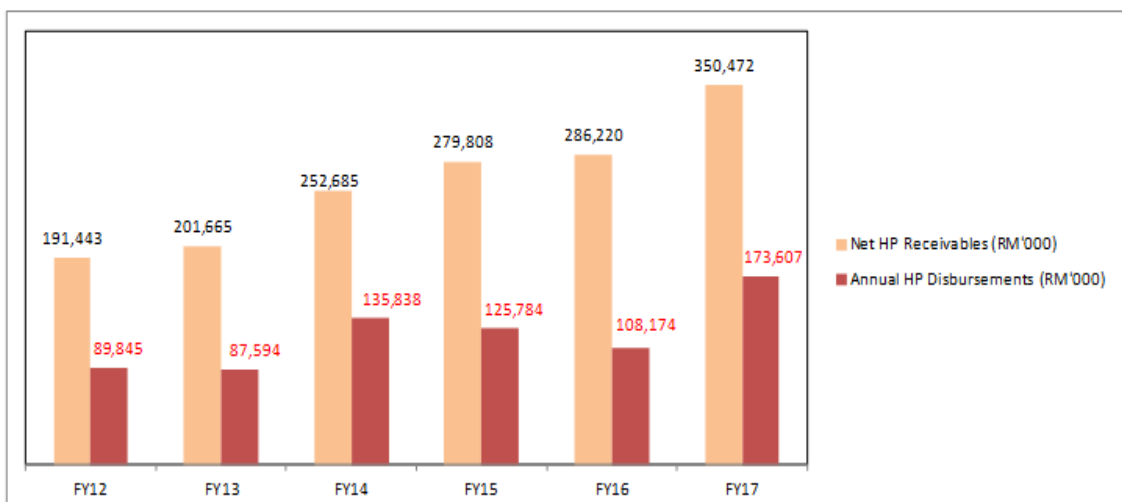
Since listing in 2012, ELKD has enjoyed steady growth. Over the last six years, the compounded annual growth rate (CAGR) for its revenue and net profit was 19.6% and 7.6% respectively, supported by continuous growth in financing receivables and steady interest rate environment.



In the recent years, the cheap funding cost due to the prevailing low interest rate environment has augured well for ELKD’s profit margins. ELKD commands an average HP net margin (FY13-FY17) of 33.78%. Its high net margin is best explained as the case in FY17, the average HP interest rate charged by the Company is approximately 9.8% flat rate per annum with an average HP tenure of 5 years. This translates to an effective interest rate of approx 12.9% to 18.2% depending on the tenure. Based on the Company’s cost of borrowing of approx 5.2% to 5.5%, the difference between the effective interest charged to the hirers and the cost of borrowing is the net margin enjoyed by the Company.

b) **Net HP Receivables & Annual HP Disbursements**

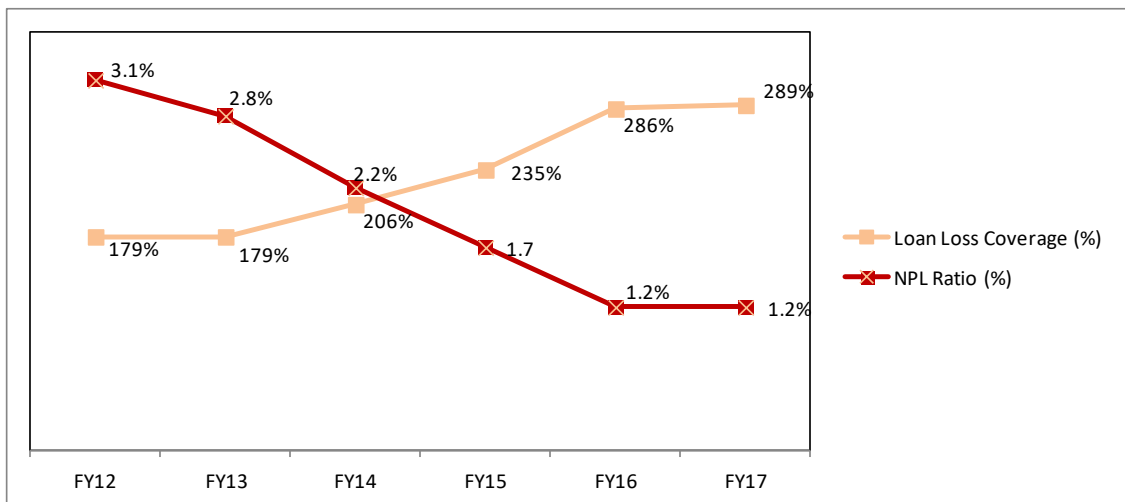
ELKD’s net HP receivables have been expanding at a CAGR of 12.9% due to steady demand for its HP loans, and low market penetration rate - It is estimated that ELKD is financing less than 1% of the total used-passenger cars registered in KL and Selangor. Hence, despite weak overall demand for used cars in the past few years, the Company’s annual disbursements held relatively steady. In fact in FY17, the Company made a conscious decision to increase its portfolio and net HP receivables rose 22.5% Y-o-Y to RM350.5m.



**c) NPL Ratio & Loan Loss Coverage**

ELKD manages its portfolio prudently and as a result, the NPL ratio for each of the past 2 years amounted to only 1.2%. The improvement of NPL ratio in the midst of strong loan growth in the past has clearly demonstrated management’s strong capabilities in credit control and management. The low level of NPL is partly mitigated by internal policy of capping loan amount per disbursement at RM20k, which implied the maximum potential loss per hirer. The Company’s average HP distribution now stands approx. RM16k per hirer.

Despite the declining trend of NPL, management continues to be prudent. The Company has been raising its loan loss coverage ratio to a current high of 289%.

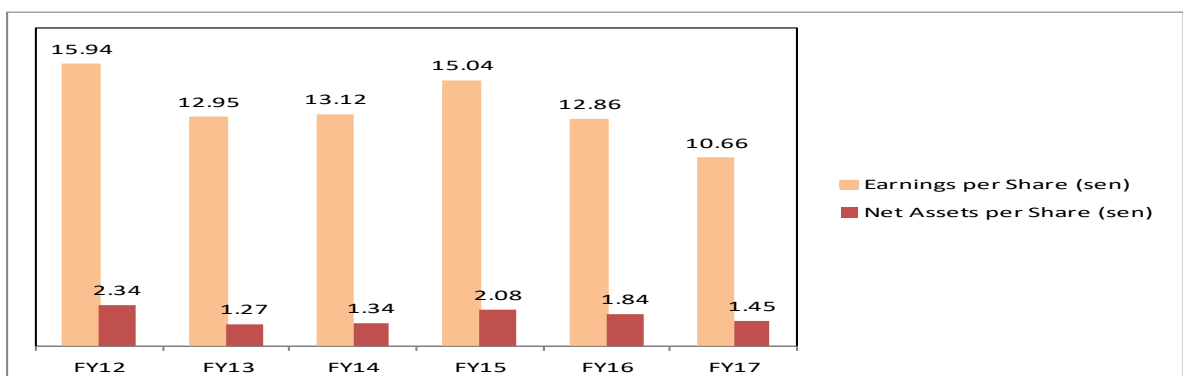


**6. Capital Structure**

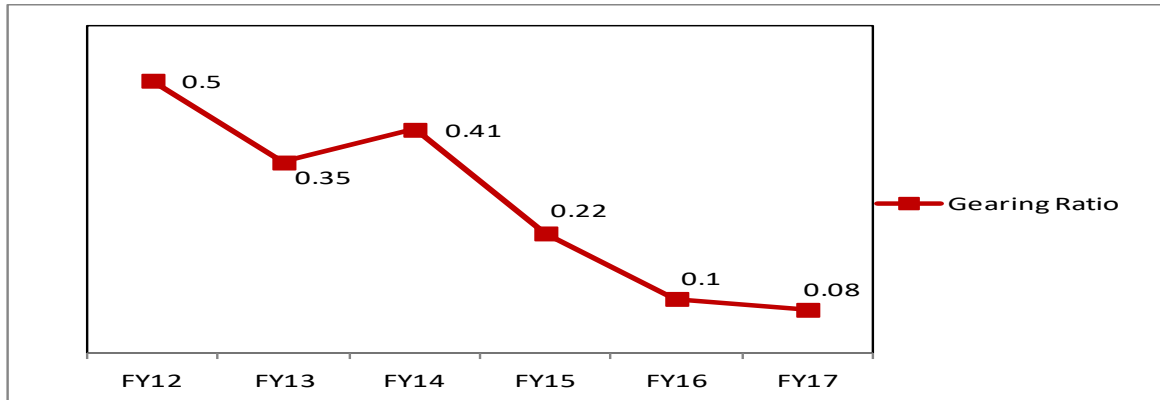
To date, management has funded the growth of its business mainly utilising shareholders funds. We believe that when operations scale up to a more sizeable level in the medium term, management will employ more leverage. But for now, the preference is for shareholders’ equity. Since listing in 2012, there have been three Rights Issues over the years:

- 2014 4 ICULS:5 @ RM1.00 ( RM100m raised)
- 2015 1:2 @ RM1.20 (RM71.76m raised)
- 2017 1:5 @ RM1.16 (RM60m raised)

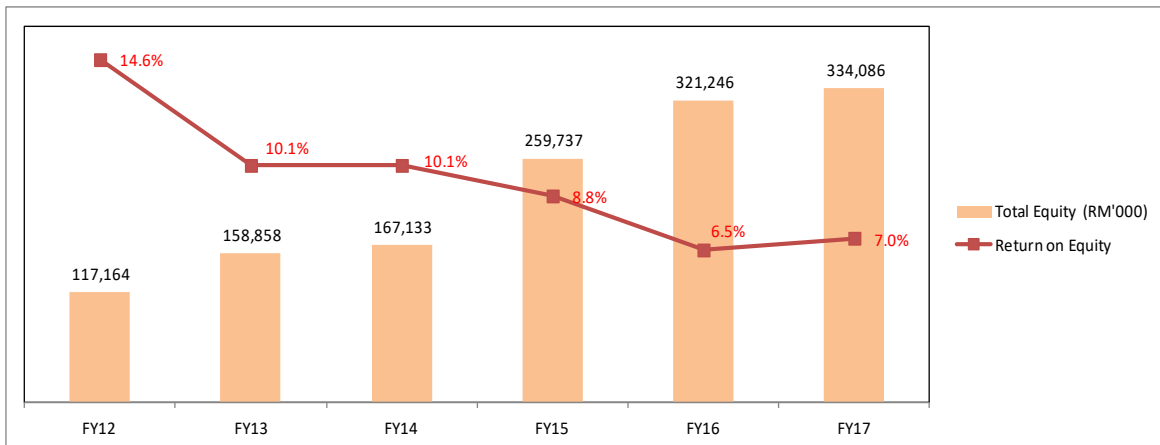
As a result, despite strong net profit growth, the earnings per share growth has been diluted due to the corresponding increase in share base. The dilution has also impacted its net assets per share. We expect further effect of dilution following the completion of 2017’s Rights Issue, and ongoing gradual ICULS conversion.



The Company has lowered its gearing over the years.

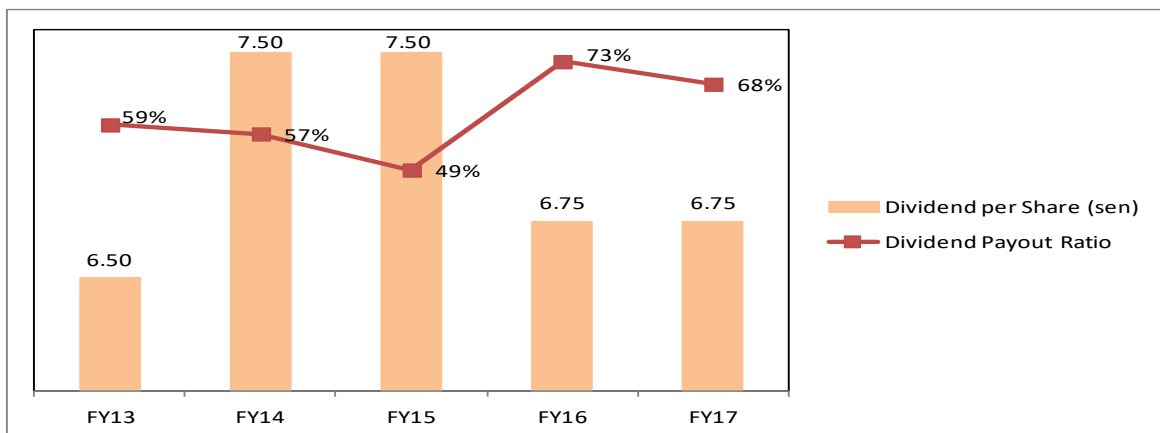


Return on equity (ROE) has been declining, and this reflects its conservative capital structure (relies more on equity than debt for funding).



**7. Dividend**

ELKD has consistently paid out dividends since FY13 and starting FY16, the Company has adopted a dividend policy to distribute not less than 60% of annual net profit.



We believe the Company will strive to maintain a dividend yield of no less than 5% given that the average past 5-year dividend yield is 5.4%. However, we expect a slight lower dividend per share in FY18 and FY19 due to the enlarged share base.

**8. Earnings Forecasts**

From a macroeconomic standpoint, GDP growth has a significant impact on the sale of new and used vehicles in Malaysia. According to Malaysian Institute of Economic Research, Malaysia’s GDP for 2017 is projected to grow at 4.5%, driven by domestic demand on the back of strengthening external demand, along with the recovery of commodities prices. The growth momentum is expected to intensify into 2018 with expected growth of 4.7% - 5.3%.

The above favourable economic outlook bodes well for the overall local vehicle industry going forward. While used car sales may remain subdued due to a host of other reasons, we believe some segments will continue to do well, especially that of entry-level small used car, and premium used car segments. As such, we expect ELKD to continue benefitting. Also, given its low market penetration rate, growth of its business also depends on how aggressive management decides to be.

Given the above scenario, we believe ELKD’s net receivables will continue to trend higher underpinned by various business strategies. However, we are projecting conservative annual HP disbursements of RM160m and RM170m for FY18 and FY19 respectively after last year record high disbursements since listing. Correspondingly, we assume net HP receivables of RM352m and RM374m for FY18 and FY19 respectively. We also project a low single digit revenue and net profit growth for furniture segment for the next 2 years.

**9. Peer Comparison**

There are two listed companies, AEON Credit and RCE Capital that have similar business model (consumer financing) as ELKD. Only one of AEON Credit’s business segments, i.e. auto financing competes directly with ELKD.

<b>Key Performances</b>	<b>ELKD</b>	<b>AEON Credit</b>	<b>RCE Capital</b>
Net Margin	24.3%	24.1%	35.4%
Gearing Ratio	0.08	4.77	2.39
Return on Equity (ROE)	7.0%	28.9%	17.6%
Dividend Yield (5-year average)	5.4%	3.9%	4.1%

- ELKD’s net margin is commendable though its loan portfolio is very much smaller compared to the other two companies.
- ELKD generates ROE that is much lower versus the comparative peers because it employs minimal gearing.
- ELKD has the highest dividend yield among the three companies.

In term of share price performance, after taking into all the corporate exercise adjustments, ELKD’s share price has been largely flat since listing (IPO price is RM1.16), underperforming that of AEON Credit and RCE Capital, as well as the broader market during the period.

**10. Key Investment Risks**

- Weak HP demand  
The local HP market for used cars is sensitive to macroeconomic conditions. Sub-par GDP growth may lead to the deterioration of consumer sentiment, employment and income levels, leading to delay or cancellation of purchasing used cars.
- Improving public transport  
Potential hirers may opt for public transport instead, which is improving in terms of reach as well as connectivity in Klang Valley



- Interest rate risk  
The Company's profit margins are susceptible to fluctuation in interest rate as a result of its interest-bearing borrowings to fund HP financing.
- Higher-than-expected NPL  
Household debt in Malaysia has been on the rise. There is concern that the Company may take on higher credit risk arising from over-leveraged hirers.
- Affordable new cars  
With more new vehicle launches at attractive prices, we may expect a decline in used car market sales volume to affect the Company's bottom line.

## 11. Latest Rights Issue

ELKD's latest Rights Issue comprising 1:5 @ RM1.16 per rights share went ex-Rights on 4 August 2017. The Rights Issue is renounceable, and the last date of trading for the provisional rights is 15 August, with 23 August being the final date for payment and acceptance.

This exercise will raise proceeds of about RM60m, mainly for the purpose of HP disbursements. This is in line with the current practice of funding future growth utilising equity rather than debt.

## 12. Valuation and Recommendation

ELKD is characterised by its conservative capital structure and prudent expansion strategy. Given this, its historical growth rates and ROE lag behind other local consumer financing players. The Company however has significant room for growth, considering its HP portfolio of RM512m is small relative to the total market size for used motor vehicle HP which is estimated at RM20b to RM25b.

Nevertheless, we are positive about the Company for the following reasons:

- Market leader in its segment
- High profit margins with low NPL
- Prudent management style in managing growth and credit risk
- Expected dividend yield of above 5%

Ex-Rights, ELKD is currently trading at FY18 forward price-to-book value (P/BV) of 1.02 on a fully diluted basis, which is lower compared with RCE Capital's forward FY18 P/BV of 1.4x. We believe this is due to its lower ROE [RCE Capital (17%) vs ELKD (7%)], and conservative growth profile.

(Note that to arrive at fully diluted share base, we assume maximum scenario for the number of Rights Shares to be issued, plus full conversion of all the outstanding ICULS into ordinary shares)

From a PE multiple perspective, ELKD is currently trading at a relatively high prospective PE of 15x versus RCE Capital of 8.8x. ELKD's higher PE, in our opinion, is a reflection of its conservative capital management, where its financial performance could be significantly stronger if management employed higher leverage in conducting its business. Additionally, investors at this juncture are pricing the stock on a yield basis, where its healthy dividend stream lends support to the share price at current levels.

We believe that the stock is a **HOLD** at current level, and a 1x P/BV ratio is fair. The stock is trading in line with FY18 estimated book value of RM1.17/share. Also, as discussed, the anticipated dividend yield of about 5% will continue to underpin ELKD's share price.

In the longer term, when management decides that shareholders' equity has grown to a sufficient size and employs leverage more aggressively to drive its HP business, we believe that there is potential for a healthy re-rating. Its management is highly experienced, the market potential is still vast and largely untapped, and the stock's financial ratios (e.g ROE, ROCE, margins etc) will exhibit strong improvement.

**Share Price Chart of ELKD****Disclosures/Disclaimer**

Investment ratings:

Buy (generally >10% upside over the next 12 months)

Hold (generally negative 10% downside to positive 10% upside over the next 12 months)

Sell (generally >10% downside over the next 12 months)

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