BCT Asia advisory

BURSA MidS

UPDATE REPORT **13 AUGUST 2018**

Name of PLC: *ELK-Desa Resources Bhd (ELKD)*		***PLC Website:*** *www.elk-desa.com.my*	
Business Summary: *Involved in hire purchase financing for used motor vehicles, insurance agency business and furniture business*			
Top Three Shareholders: *Teoh Hock Chai@ Tew Hock Chai*			*30.5%*
Dr Yeong Cheong Thye@ Yeong Yue Chai			*8.7%*
Market / Sector:	*Main / Finance*	***Stock Code:*** ***Bloomberg Ticker:***	*5228* *ELK MK*
Market Capitalisation:	*RM 361.07m*	***Recommendation:***	*BUY*
Target Price:	*RM 1.42*	***Expected Capital Gain:***	*18.3%*
		Expected Div Yield:	*5.8%*
Current Price:	*RM 1.20*	***Expected Total Return:***	*24.1%*

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Key Stock Statistics	**2017**	**2018**	**2019F**	**2020F**
EPS (sen)	10.0	8.7	9.6	10.7
P/E (x)	11.6	13.4	12.1	10.9
EPS ex-EI (sen)	10.0	8.7	9.6	10.7
P/E ex-EI (x)	11.6	13.4	12.1	10.9
Net Dividend/Share (sen)	6.8	6.8	6.8	6.8
NTA/Share (RM)	1.45	1.33	1.42	1.53
Book Value/Share (RM)	1.45	1.33	1.42	1.53
Issued Capital (mil shares)	230.3	298.4	298.4	298.4
52-weeks Share Price Range (RM)				1.14-1.25
Estimated free float				38.2%
Average volume (shares)				57,550

Per Share Data	**2017**	**2018**	**2019F**	**2020F**
Year-end 30 Sept				
Book Value/Share (RM)	1.45	1.33	1.42	1.53
Operating CF/Share (sen)	(20.6)	(8.6)	(3.0)	4.4
EPS (sen)	10.0	8.7	9.6	10.7
Net Dividend/Share (sen)	6.8	6.8	6.8	6.8
P/E (x)	11.6	13.4	12.1	10.9
P/Cash Flow (x)	(5.6)	(13.5)	(38.7)	26.4
P/Book Value (x)	0.8	0.87	0.81	0.76
Dividend Yield (%)	5.8	5.8	5.8	5.8
Payout Ratio (%)	67.6	77.7	70.6	63.6
ROE (%)	7.0	7.1	6.7	6.8
Net Gearing (%)	3.4	0.7	1.1	-3.0

P&L Analysis (RM mil)	**2017**	**2018**	**2019F**	**2020F**
Revenue	94.5	104.1	110.4	120.0
EBITDA	30.8	38.4	40.4	44.4
Depreciation & amort	(0.6)	(0.6)	(0.6)	(0.6)
Pre-tax Profit	30.6	35.3	37.7	41.9
Net Profit	23.0	25.9	28.6	31.8
EBITDA Margin (%)	32.6	36.9	36.6	37.0
Pre-tax Margin (%)	32.4	33.9	34.2	34.9
Net-Margin (%)	24.3	24.9	25.9	26.5

1. Investment Highlights/Summary

- Net HP receivables have been expanding at a CAGR of 14.7% (FY13-FY18) due to steady demand for its hire purchase loans, while NPL has undoubtedly improved from a high of 2.2% in FY14 to a commendable 1.0% in FY18.

- In the near to medium term, we believe the Company will continue to do well, driven by coverage of new segment of the HP market. Management is now beginning to tap growth from the RM20,000 – 35,000 segment. The net gearing of the Company is near to net cash, hence its balance sheet is able to support this expansion. This is also expected to drive ROE improvement.

- The Company has been paying out above 60% in the past 3 years with an average payout ratio of 72%. This makes the stock attractive from a yield perspective - dividend yield has been consistently above 5% since FY13.

- Maintain BUY recommendation. We are positive on the stock as we believe market potential is vast and ELK has ample capacity to leverage more aggressively to drive its HP business. In tandem with more debt employed, the stock's financial ratios will likely exhibit further improvement in the coming years.

2. Corporate Updates

We held a briefing for ELK Desa recently and it was attended by close to 40 participants from the investment community.

Hire Purchase Segment

- Management emphasized that ELK Desa covers a niche market, and targets buyers of small value second-hand vehicles within the age profile of 6 to 15 years old, and with engine capacity of less than 2,400cc. This segment is typically not a priority for financial institutions, hence ELK does not compete head on with banks. Its hire purchase financing amount is capped to not more than RM35,000 per hirer to manage credit risk. The ceiling has only recently been expanded to as much as RM35,000 where in the past, ELK used to focus on RM20,000 and below. This broadens the target market away from the national car segment, and expands the HP business to encompass Japanese makes like Honda, Toyota and Nissan. Most importantly, ELK Desa has strategized to have a broad hirer base to reduce risk and not rely on a single large hirer. It has a large network of motor vehicle dealer numbering more than 1000 for referral of hirers, and hirer base of 35,000.

- Besides hire purchase, the Company also cross-sells both motor and non-motor insurance to the hirers through its subsidiary namely ELK-DESA Risk Agency which is an insurance agent for Tokio Marine Insurans (Malaysia) Bhd and Berjaya Sompo Insurance Bhd. Although earnings contribution is small, the insurance premium production and commission have been growing healthily at a 4-year CAGR of 3.0% and 2.4% respectively.

Furniture Segment

- Management has been working hard to diversify its earnings base but still maintaining its overall exposure to the consumer segment. For every household, furniture is a must and The Company has a vision to penetrate the furniture segment which they believe continues to hold good potential, despite the fragmented nature of the industry. Hence, ELK-Desa Furniture Group started operations about 3 years ago as a furniture retailer and wholesaler. Management shared that this venture is to help them familiarise with the industry. If opportunity arises in the longer term, they may expand into furniture HP business. The roll-out will be similar to its current model, where market penetration will be undertaken through furniture seller or dealers to capture a bigger pie of the market within a short period of time.

- Meanwhile, the Company also has a money lending licence which was secured in November 2017. This will also provide opportunities for future business expansion in the longer term.

Investment merits

- ELK Desa's net HP receivables have been expanding at a CAGR of 14.7% (FY13-FY18) due to steady demand for its hire purchase loans, and relatively low market penetration rate - It is estimated that ELK Desa is financing about 0.6% of the total used-passenger cars registered in KL and Selangor. In 2017, the Company made a conscious decision to increase its portfolio, and as a result, net HP receivables rose 22.4% y-o-y to RM350.5m. Its annual disbursement also jumped 60.5% y-o-y to RM173.6m. FY18 net HP receivables grew 14.3% y-o-y. Given the recent expansion in coverage to a maximum financing amount of RM35,000, management hopes to maintain its 15% p.a. growth rate.

- To ensure the integrity of the Company's HP assets, all non-performing loans (NPL) have been fully impaired in the financial statements. As it stands, the Company's NPL has improved from a high of 2.2% in FY14 to a lowest rate of 1.0% in FY18. Its credit loss charges have been manageable at the range of 5.5% to 6.3%.

- The Company's net gearing remained low at 0.7% in FY18 which provides ample room to improve the return on equity (ROE). Management has intention to increase the usage of borrowings and this should result in ROE improvement. ELK's ROE currently stands a 6.5% in FY18, as compared with 9.8% back in FY14.

- A dividend policy of distributing not less than 60% of net profits was announced in 2015. The Company has also been paying above 60% in the past three years with an average payout ratio of 72%. This makes the stock attractive as it has been paying more than 5% dividend yield continuously for all these years since FY13. For FY19-20E, we conservatively assume the Company maintains its 6.75sen dividend payout per annum, which translates to an attractive yield of 5.8%.

3. Earnings Outlook

- In near to medium term, we believe the Company will continue to do well, especially given the new coverage area of growth. We believe net receivables will continue to trend higher underpinned by management's direction to expand its HP portfolio. The net gearing of the Company is near to net cash position hence its balance sheet is able to support this expansion. For now, we are projecting annual HP disbursements of RM200m and RM240m for FY19-20E. Correspondingly, we assume net HP receivables of RM460m and RM530m for FY19-20E respectively. We also project a low single digit revenue and net profit growth for furniture segment for the next 2 years. We maintain our earnings estimates of RM28.6m and RM31.8m for FY19-20E.

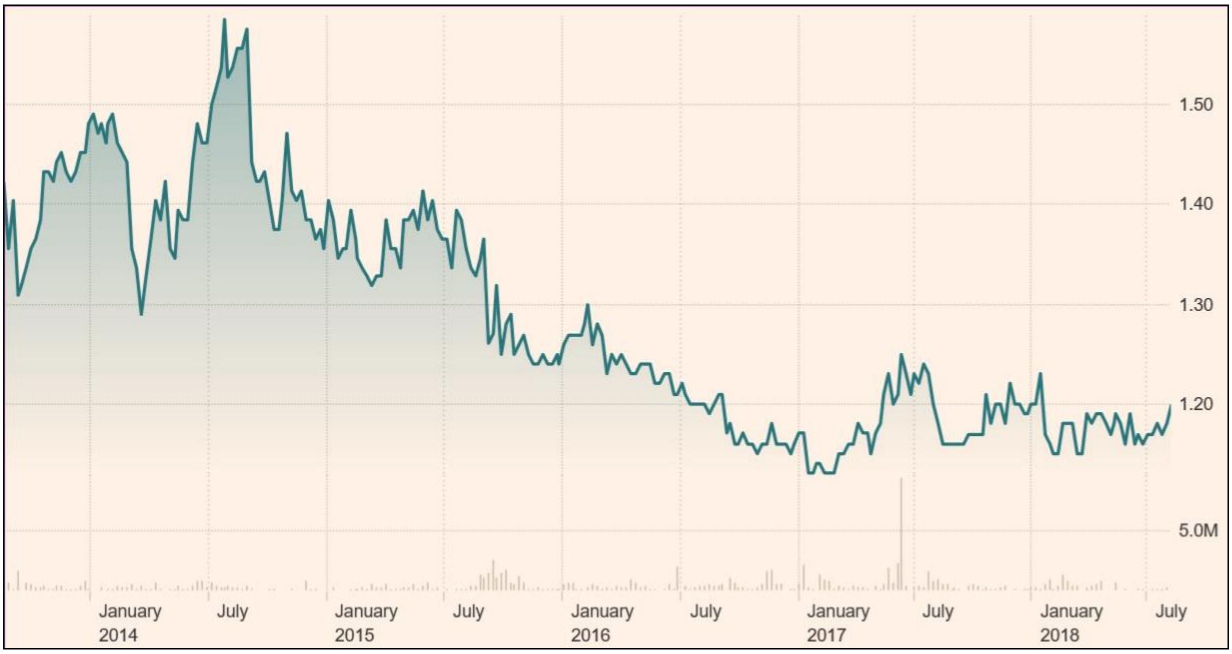
- For long term, we are impressed by management's vision and strategic plan with key long-term objectives to diversify income stream and grow the Company. Although it is still a long way to go, the framework is being established now and we are positive on its prospects.

4. Valuation and Recommendation

- ELKD is currently trading at a relatively high PE of 11x versus RCE Capital of 5.0x. 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.

- Hence, we are maintaining our BUY recommendation. We are positive on the stock as we believe management has ample capacity to leverage more aggressively to drive its HP business. In addition, its management is highly experienced, the market potential is still vast and largely untapped, and the stock's financial ratios will likely exhibit improvement in the coming years.

Share Price Chart



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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