RHB Small Cap Asean Research

Malaysia Trading Idea

Shariah Compliant

11 August 2021

Consumer Non-cyclical | Food Products

Kawan Food (KFB MK)

Not Rated

Riding On Evolving Frozen Food Consumption

Fair Value (Return):	MYR2.51 (+35%)
Price:	MYR1.86
Market Cap:	USD158m
Avg Daily Turnover (MYR/USD)	0.34m/0.08m

- **MYR2.51 FV on 25x FY22F P/E**. Kawan Food, a leader in the domestic frozen paratha market, is expected to benefit from a shift in consumer preference for convenience food, while its ready e-commerce channel could help to expand its market reach. As the global economy recovers, we anticipate the company's food services revenue to improve, supported by its ready capacity. We also believe its ongoing cost optimisation and automation initiatives should widen margins ahead.
- **Demand for convenience food on the rise.** As the pace of life continues to accelerate in tandem with globalisation, the shift in consumer preference towards frozen products has been picking up, as people opt for products that require less time and effort to prepare. The COVID-19 pandemic has further accelerated this shift in preference. Studies show that demand as of May was still at double digits compared to pre-pandemic (2019) levels, implying that demand for frozen food will remain robust, as consumers continue to opt for convenient and healthier food with a longer shelf life. Overall, we expect a FY20-22 revenue and earnings CAGR of 8% and 13%.
- **Increasing presence through e-commerce shopping.** Kawan Food's e-commerce sales surged by 651% YoY to c.MYR1m in FY20. While the figure was small, we believe the adoption of digitalisation will help it foster stronger ties with direct customers. With its customer loyalty programme in place, we think this could help to attract new and retain existing customers. Meanwhile, the customer data accumulated would help it craft a more effective marketing strategy while optimising production – which would eventually improve sales and profitability.
- **Continuous operational improvements via cost optimisation and a higher reliance on automation.** The installation of its solar panel system has been completed in 2H. This should reduce the cost of power consumption and bring in cost savings of about MYR1.2-1.3m annually. Meanwhile, we believe a higher reliance on automation could help address the issue of manpower shortage. We expect its FY21-23 PAT margin to grow to c.13%, post cost optimisation and operational improvements.
- **A potential opportunity?** Kawan Food's weak share price performance in the last 12 months could be due to the mismatch in earnings expectations – earnings post 2Q20 were lower than that quarter. This was largely due to the spike in purchases made during the first MCO in 2Q20. As demand for its products is growing, we think the divergence between its financial performance and share price trend may present a potential opportunity for investors.
- **Downside risks:** Product tampering & food contamination, fluctuation in raw material prices, and heightened competition.

Analyst

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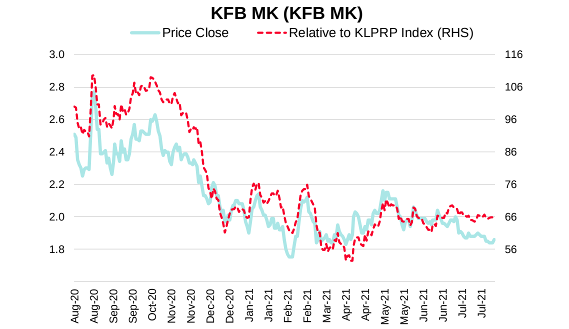
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(10.6)	(2.6)	(13.5)	3.3	(27.4)
Relative	(4.4)	(1.4)	(6.6)	3.5	(37.1)
52-wk Price low/high (MYR)					1.75 – 2.77



Source: Bloomberg

Forecasts and Valuation	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Total turnover (MYRm)	214	255	270	296	315
Recurring net profit (MYRm)	12	28	29	36	42
Recurring net profit growth (%)	(46.5)	129.8	3.6	24.1	15.6
Recurring P/E (x)	54.85	23.87	23.04	18.56	16.06
P/B (x)	2.1	1.9	1.7	1.6	1.5
P/CF (x)	16.07	12.86	15.66	13.88	11.87
Dividend Yield (%)	1.3	1.3	1.6	1.9	2.1
EV/EBITDA (x)	19.26	12.44	11.45	9.41	7.99
Return on average equity (%)	3.8	8.4	7.9	9.0	9.8
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash

Source: Company data, RHB

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

Financial Exhibits

Asia
Malaysia
Consumer Non-cyclical
Kawan Food
KFB MK
Not Rated

Valuation basis

25x FY22F P/E

Key drivers

i. Growing demand for convenience food;
ii. Increasing its presence through e-commerce;
iii. Continuous operational improvements through cost optimisation and a higher reliance on automation.

Key risks

i. Product tampering & food contamination;
ii. Fluctuation in raw material prices;
iii. Heightened competition.

Company Profile

Kawan Food is one of the Malaysia's leading exporters, and one of the largest manufacturers of frozen Asian food delicacies worldwide, It is principally involved in the manufacturing, sales, trading and distribution of frozen food products. Products include paratha, chapatti, spring rolls, frozen vegetables, finger food, buns and other baked goods, as well as desserts.

Financial summary (MYR)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Recurring EPS	0.03	0.08	0.08	0.10	0.12
DPS	0.03	0.03	0.03	0.03	0.04
BVPS	0.90	0.96	1.08	1.15	1.22
Return on average equity (%)	3.8	8.4	7.9	9.0	9.8

Valuation metrics	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Recurring P/E (x)	54.85	23.87	23.04	18.56	16.06
P/B (x)	2.1	1.9	1.7	1.6	1.5
FCF Yield (%)	3.1	5.0	4.1	5.0	6.2
Dividend Yield (%)	1.3	1.3	1.6	1.9	2.1
EV/EBITDA (x)	19.26	12.44	11.45	9.41	7.99
EV/EBIT (x)	39.59	18.87	17.34	13.48	11.11

Income statement (MYRm)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Total turnover	214	255	270	296	315
Gross profit	72	101	100	116	128
EBITDA	33	49	52	61	68
Depreciation and amortisation	(17)	(17)	(18)	(18)	(19)
Operating profit	16	32	34	43	49
Net interest	(1)	(0)	0	0	0
Pre-tax profit	15	32	34	43	49
Taxation	(3)	(4)	(5)	(7)	(8)
Reported net profit	12	28	29	36	42
Recurring net profit	12	28	29	36	42

Cash flow (MYRm)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Change in working capital	7.4	(2.5)	(29.4)	(6.1)	(4.3)
Cash flow from operations	41.6	52.0	42.7	48.2	56.4
Capex	(21.2)	(18.3)	(15.0)	(15.0)	(15.0)
Cash flow from investing activities	(21.7)	(24.1)	(15.6)	(15.0)	(15.0)
Dividends paid	(9.0)	(9.0)	(10.8)	(12.6)	(14.4)
Cash flow from financing activities	(9.3)	(10.2)	(12.7)	(14.4)	(16.2)
Cash at beginning of period	39.5	48.8	66.3	80.7	99.5
Net change in cash	10.6	17.7	14.4	18.7	25.2
Ending balance cash	48.8	66.3	80.7	99.5	124.7

Balance sheet (MYRm)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Total cash and equivalents	49	66	81	99	125
Tangible fixed assets	244	246	243	240	236
Total investments	9	8	8	8	8
Total assets	383	417	459	483	509
Short-term debt	6	9	8	7	6
Total long-term debt	9	6	5	4	3
Total liabilities	58	71	70	70	69
Total equity	325	346	389	413	440
Total liabilities & equity	383	417	459	483	509

Key metrics	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Revenue growth (%)	7.1	19.0	6.0	9.7	6.2
Recurrent EPS growth (%)	(46.5)	129.8	3.6	24.1	15.6
Gross margin (%)	33.5	39.7	37.0	39.1	40.8
Operating EBITDA margin (%)	15.2	19.3	19.2	20.6	21.7
Net profit margin (%)	5.7	11.0	10.8	12.2	13.2
Dividend payout ratio (%)	73.7	32.1	37.1	34.9	34.5
Capex/sales (%)	9.9	7.2	5.6	5.1	4.8
Interest cover (x)	15.9	41.6	80.5	99.7	120.5

Source: Company data, RHB

Riding On Evolving Frozen Food Consumption

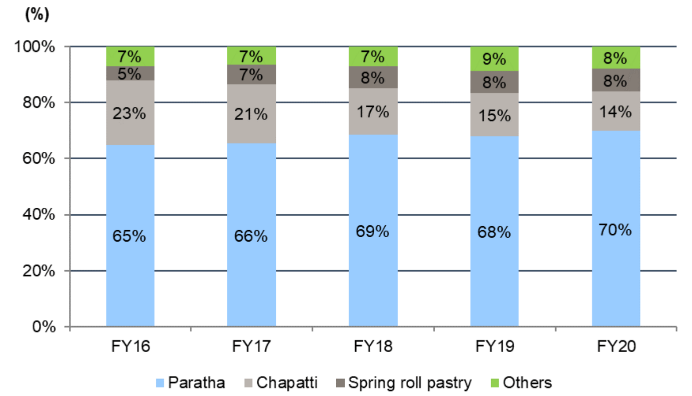
The largest frozen paratha producer in Malaysia

Kawan Food is one of Malaysia's leading exporters, and one of the largest manufacturers of frozen Asian food delicacies worldwide. It is principally involved in the manufacturing, sales, trading and distribution of frozen food products. The company's products include paratha, chapatti, spring rolls, frozen vegetables, finger food, bun and baked goods, and desserts. Products are sold under five brands – Kawan, KG Pastry, Veat, Passion Bake, and Aman. To our best knowledge, it has a c.50-60% market share in Malaysia.

Among its products, paratha accounts for c.40-50% of FY20 revenue. With over 40 years of experience in the industry, Kawan Food products are exported to over 37 countries via direct sales to key account customers, distributors, hotels, restaurants and caterers (HORECA), food service providers, and e-commerce (Kawan Food's own website, and through Lazada, Shopee, and Dropee). In FY20, the US was its largest export market, accounting for about 40% of export sales.

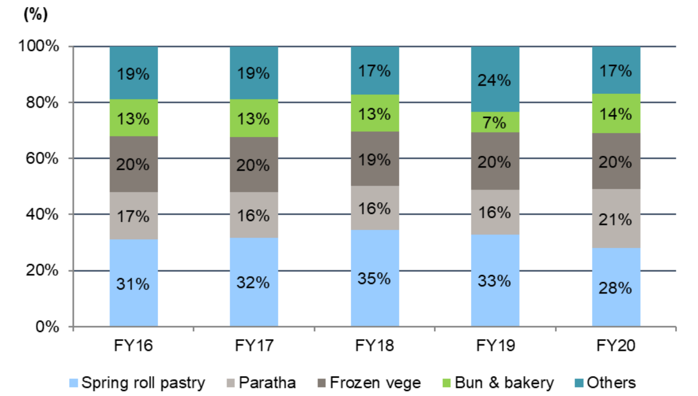
Kawan Food's manufacturing plants are located in Pulah Indah, Selangor and Nantong, China. The Pulau Indah manufacturing plant, which began operating in Jul 2018, is running at a c.50-55% utilisation rate temporarily, in view of its reduced workforce capacity at present. Meanwhile, the built-up area of its China facility spans 16,000 sqm – which is about one-third of its 49,404-sqm Pulau Indah plant. As of FY20, its turnover from China made up about 5.9% of total revenue.

Figure 1: Export sales by product category



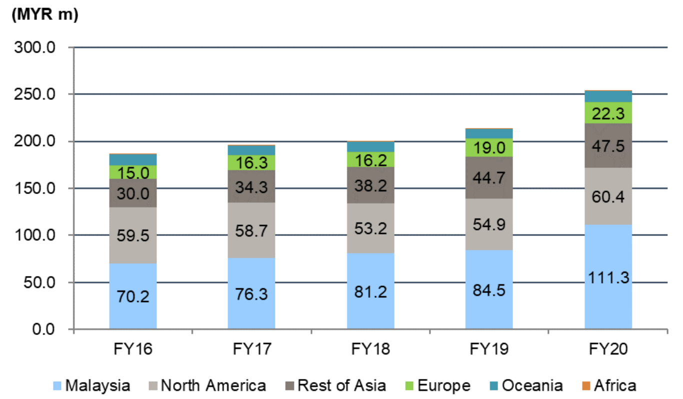
Source: Company data

Figure 2: Domestic sales by product category



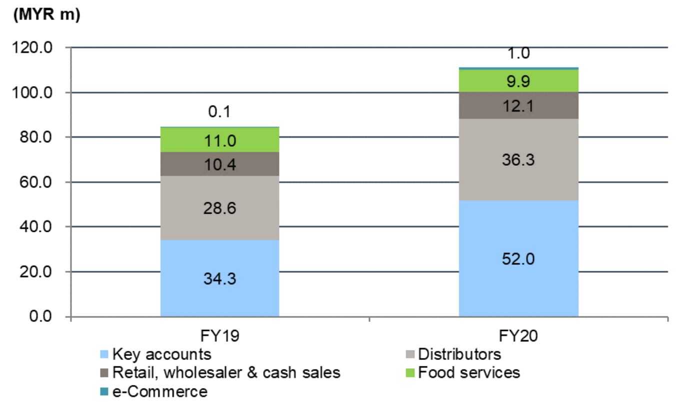
Source: Company data

Figure 3: Revenue by geographical location



Source: Company data

Figure 4: Malaysia market channels



Source: Company data

Demand for convenience food on the rise

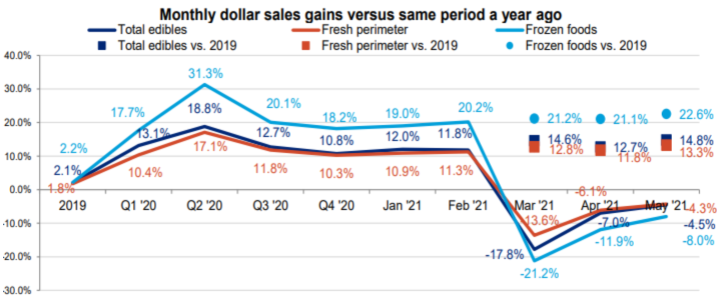
As the pace of life continues to accelerate in tandem with globalisation, this has led to a shift in consumer preference when it comes to food selection. Demand for frozen products that require less time and preparation (vs cooking from scratch) has grown over the years. The COVID-19 pandemic, movement and dine-in restrictions boosted the demand for home cooking and frozen products, as people now spend far more time dining at home.

While we do not expect a sudden hike in sales (like what happened in the first MCO, from March to June last year), we estimate revenue to grow by 6% YoY this year. We believe the shift in consumer preferences has contributed to higher demand for frozen goods.

According to studies conducted by 210 Analytics, IRI, and the American Frozen Food Institute (AFFI), demand for frozen food as at May was lower than levels recorded in FY20 (Figures 5 and 6) – which we believe was due to the normalisation of consumption patterns. That said, the demand for frozen food still grew by double digits when compared to 2019, ie pre-pandemic levels. This implies the demand for frozen food continues to be robust, even though consumers in the US have started to dine outside their homes again.

As the US is its biggest export market, we believe the higher demand for frozen food (vs pre-pandemic levels) could be a positive indicator for Kawan Food. Looking at the numbers, the group's average quarterly revenue since the pandemic began is c.MYR60m, vs c.MYR50m prior to COVID-19. This is despite the fact that not all countries have movement and social distancing restrictions in force currently. As such, we think that frozen food may remain in demand, which may continue to grow globally post recovery from the pandemic.

Figure 5: Monthly dollar sales gain vs that of the same period a year ago



Source: IRI, Integrated Fresh, total US, MULO

Figure 6: May 2021 sales grew by double digits from the base of 2019

Frozen food	Dollar sales	Dollar gains vs. 2019	Dollar gains vs. 2020
w.e. 5/2/21	$1.2B	+19.7%	-13.5%
w.e. 5/9/21	$1.3B	+21.0%	-11.5%
w.e. 5/16/21	$1.3B	+22.8%	-7.2%
w.e. 5/23/21	$1.3B	+21.9%	-7.0%
w.e. 5/30/21	$1.3B	+27.9%	-0.1%

Source: IRI, Integrated Fresh, total US, MULO

In Malaysia, its plant suspended operations over 14-21 Jun, as its factory and worker hostel underwent sanitisation. However, we do not expect significant interruptions ahead, as its inventory level is still manageable – products from its China facility can fulfil demand, since the plant has been unaffected and remains fully operational.

As the number of domestic daily new COVID-19 cases remain high, we expect consumers to: i) Reduce the frequency of their visits to physical stores, to reduce potential exposure to the coronavirus; or ii) increase online purchase ticket items to reduce the number of delivery trips, or make bulk purchases in order to qualify for free delivery services. As such, we expect consumers to continue to opt for convenient and healthier food (vs fresh food that lasts for a shorter time) with a longer shelf life.

Overall, we estimate it to chart FY20-22 revenue and earnings CAGRs of 8% and 13%. Note that Kawan Foods' food services segment (sales to restaurant chains and HORECA) contributed 3.9% of FY20 revenue (FY19: 5.1%). While the growth in HORECA sales should improve in the longer run as the global economy recovers, the group is looking to expand sales to restaurant chains for now – as restaurant chains have done better than the HORECA segment, when there are dine-in restrictions and the demand for food delivery services picks up.

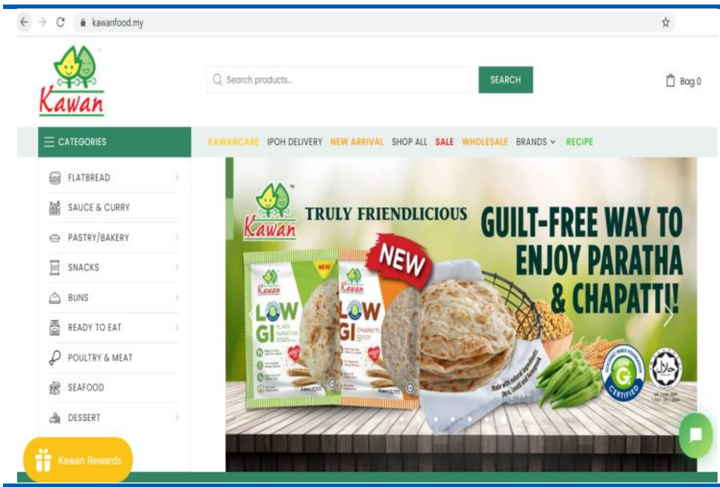
Increasing presence through e-commerce

In 2018, to expand its market reach, Kawan Food developed its e-commerce platform to sell directly to consumers (B2C) and small business retailers (B2B). Sales from e-commerce grew to c.MYR1m (+651% YoY) in FY20, from MYR133,000 in FY19. While the amount is still small at the moment, we believe the adoption of digitalisation would help it foster stronger relationships with direct customers.

As of FY20, its e-commerce store has c.14,500 registered members, of which 8,500 have joined its loyalty programme. In the loyalty programme, reward points (Kawan Points) will be awarded upon sign-up, for birthdays, purchase transactions and referring new members. Kawan Points can be converted into discount vouchers. We believe that, aside from attracting new customers and encouraging customer stickiness, the data accumulated will help it refine its marketing strategy and potentially optimise production – which would eventually lead to higher sales and profitability.

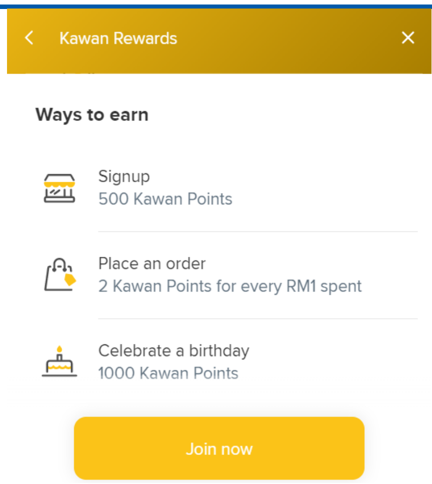
As there is room for the utilisation rate at its Pulau Indah plant to grow, we believe that any surge in orders can be comfortably supported by its coldroom storage capacity.

Figure 7: Screen capture of Kawan Food's e-commerce store



Source: Company

Figure 8: Screen capture of Kawan Food's loyalty programme rewards breakdown



Source: Company

Continuous operational improvements

The installation of its MYR7.28m solar panel system was completed in 2H. This is expected to reduce Kawan Food's cost of power consumption, and save it about MYR1.2-1.3m a year. Assuming a 10-year depreciation period, its cost of depreciation would be about MYR0.73m. The net cost savings are estimated to be MYR0.5-0.6m pa.

Note that the successful rollout of its new enterprise resource planning (ERP) system at its Malaysian facility in early FY20 has improved efficiency – in terms of coordinating production, resources, procurement, inventory, orders, invoicing and payments. Kawan Food proceeded to implement the same system in its China plant in Dec 2020.

We believe this would help provide timely data for managing the operation, which is vital for improving productivity, cost management, and response times – especially when restrictions are in place. Overall, the group is looking at cost savings in the range of 1-2% of sales, through a series of cost optimisation efforts.

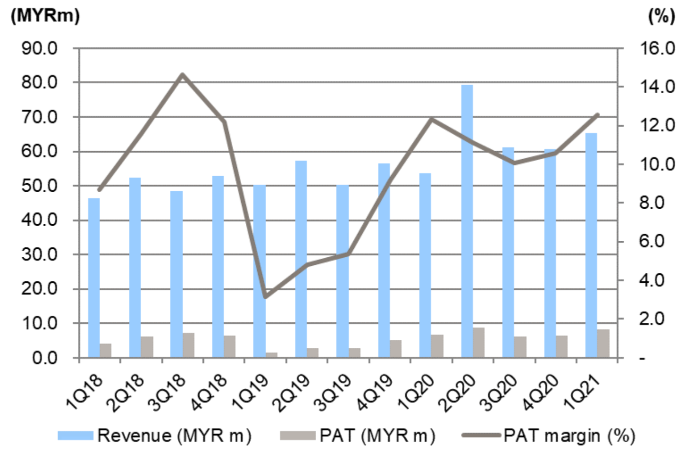
Beyond that, Kawan Food is looking at upscaling automation, by exploring digitalisation for various initiatives ie overall equipment effectiveness (OEE), lean manufacturing, integrated control systems, and a computerised maintenance management system. We believe the higher reliance on automation could be the solution to address the shortage of workers and its reduced workforce capacity issues.

Overall, its PAT margin should grow from c.11% in FY21F to c.13% in FY23F, after taking into account of cost optimisation and operational improvements.

Hedging policy in place

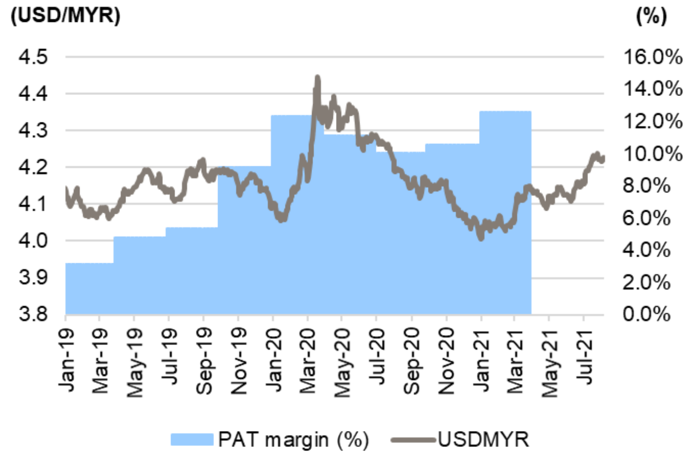
The purchase of main raw materials such as wheat flour and cooking oil is in MYR terms, while export sales are mostly denominated in USD. As of FY20, export sales comprised 50.4% of total revenue, while the remaining 49.6% are from domestic sales (in Malaysia and China). Theoretically, based on our estimates, every 10% appreciation of the USD would increase Kawan Food's PAT by c.2%. However, with a hedging policy, this is expected to minimise the FX impact to the group.

Figure 9: Higher raw material and shipping costs are partially mitigated by ongoing cost optimisation initiatives



Source: Company data, RHB

Figure 10: Hedging in place to minimise FX impact on PAT



Source: Company data, Bloomberg

Solid financials in place to cushion challenges

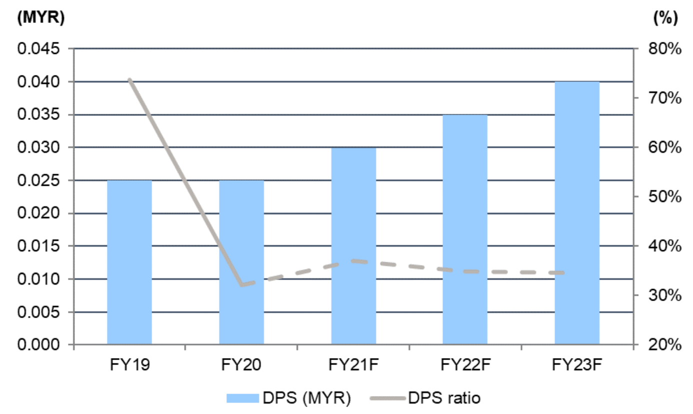
Kawan Food's 1QFY21 PAT grew by 28.2% QoQ or 23.9% YoY on higher sales (+7.8% QoQ, +21.8% YoY), mainly due to higher demand in the US and its domestic markets.

Its effective tax rate since the commissioning of the Pulau Indah plant in FY18 has been below the statutory tax rate of 24%, as its reinvestment allowance was offset against chargeable income. We expect the FY21-23F effective tax rate to be 15.5%, which is slightly higher than FY20's 13.6%.

Kawan Food is backed by a sturdy balance sheet. Even back in FY15 – when the group began building its Pulau Indah plant – it was still in a net cash position. As of 1Q21, its net cash per share stood at c.MYR0.13, vs FY20's MYR0.14.

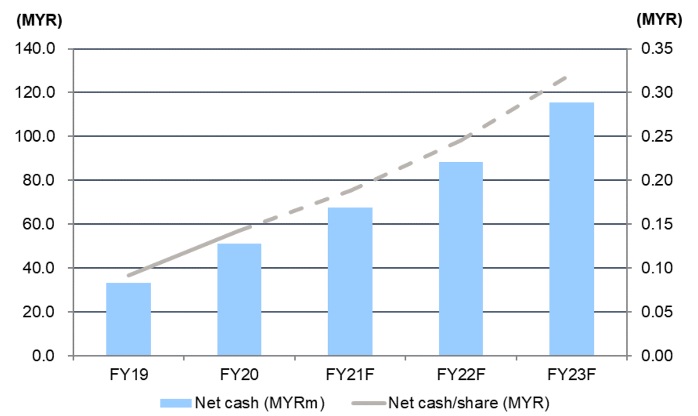
While there is no dividend policy in place, the group has been declaring dividends to reward shareholders. Assuming the dividend payout ratio remains similar to that of FY20, we anticipate FY21-23F DPS at MYR0.03-MYR0.04, implying a yield of around 2%.

Figure 11: Historical and forecasted dividends



Source: Company data, RHB

Figure 12: Historical and forecasted net cash position



Source: Company data, RHB

Valuation

Our fair value of MYR2.51 is based on 25x FY22F P/E, which is close to Kawan Food's 3-year historical mean. This is premised on:

i. Demand for food products being relatively inelastic, while the prolonged pandemic has accelerated the shift in demand for frozen products. Given the shift in dietary preference, the demand for frozen products is expected to continue to grow even post pandemic;

ii. We anticipate food services revenue (particularly from the HORECA segment) to pick up, as the global economy recovers and dine-in restrictions are uplifted;

iii. The economies of scale in production, which is supported by higher automation improving its production efficiency and profitability;

iv. Riding on the e-commerce shopping trend to expand its market reach and attract customer stickiness;

v. We believe the premium in our prescribed valuation vs domestic listed peers like PPB Group (which owns 45% of Kart Food Industries, one of Kawan Food's closest domestic competitors) is justifiable. This is because Kawan Food is the largest domestic fresh frozen paratha producer in Malaysia, with a c.50-60% market share, compared to its peer which has diversified businesses under its umbrella.

vi. Also, our valuation is still at a discount to its high market P/E of 30x – in FY16, when the group recorded its highest PAT, at MYR33m. We believe our valuation is undemanding and has room to grow – in view of the rising demand for frozen products (supported by readily available capacity), the growth potential of Kawan Foods' production efficiency, and as the global economy moves towards a recovery.

The stock is trading at a FY22F P/E of 18.6x, which is at a premium to Bursa Malaysia Consumer Product Index's FY22F P/E of 17.7x. Given: i) Its market leadership in the frozen paratha segment, ii) potential FY20-22F earnings CAGR of 13%, and iii) backed by a solid balance sheet, we believe this counter's valuation has upside growth potential.

Figure 13: Peer comparison

Company	FYE	Price 9 Aug 2021 (MYR)	Mkt cap (MYRm)	P/E (x)		Div. Yld (%)	ROE (%)	P/BV (x)	NP growth (%)	
				1-yr fwd	2-yr fwd	1-yr fwd	1-yr fwd	1-yr fwd	1-yr fwd	2-yr fwd
Regional										
Charoen Pokphand Foods	Dec	THB26.50	USD6,670	10.2	10.1	3.5	10.8	1.1	(21.1)	0.3
Thai Wah	Dec	THB6.15	USD162	14.3	11.3	2.6	6.8	1.0	822.9	27.2
Weighted average				**10.3**	**10.2**	**3.5**	**10.7**	**1.1**		
Local										
Berjaya Food	Jun	1.95	681	15.6	14.5	1.4	12.4	1.9	(328.9)	8.0
PPB Group	Dec	18.14	25,806	17.7	17.0	2.0	5.9	1.1	10.0	4.4
Power Root	Mar	1.32	554	15.9	11.3	5.5	11.7	2.1	21.1	40.6
Nestle (Malaysia)	Dec	133.30	31,212	50.3	46.1	2.0	107.6	53.7	11.5	9.1
QL Resources	Mar	5.62	13,580	47.0	40.6	0.8	11.8	5.2	(8.4)	15.7
Malayan Flour Mills	Dec	0.76	744	11.2	6.9	2.7	0.0	0.8	1122.4	61.3
Weighted average				**37.1**	**33.8**	**1.8**	**50.8**	**24.5**		
Kawan Food	Dec	1.86	669	23.0	18.6	1.6	7.9	1.7	3.6	24.1

Source: Bloomberg, RHB

Figure 14: Kawan Food's products

Source: Company

Recommendation Chart

Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2021-08-09			

Source: RHB, Bloomberg

RHB Guide to Investment Ratings

Buy: Share price may exceed 10% over the next 12 months
Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain
Neutral: Share price may fall within the range of +/- 10% over the next 12 months
Take Profit: Target price has been attained. Look to accumulate at lower levels
Sell: Share price may fall by more than 10% over the next 12 months
Not Rated: Stock is not within regular research coverage

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