Construction (Overweight ←→)

INDUSTRY INSIGHT

16 January 2018

2018 Outlook: Structural boom to continue

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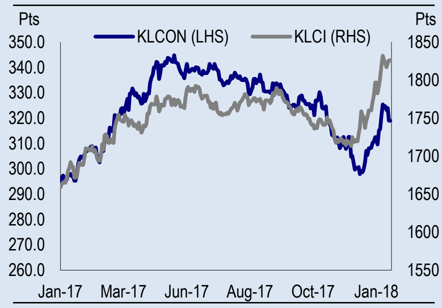
KLCON Index (319.0 pts)



Stock	Rating	Price	Target
Gamuda	BUY	5.06	5.95
IJM	BUY	2.84	3.97
WCT	BUY	1.70	2.29
MRCB	HOLD	1.25	1.26
SunCon	BUY	2.58	2.85
Kimlun	BUY	2.30	2.65
HSL	HOLD	1.47	1.48
Mitrajaya	BUY	0.95	1.15
GKent	BUY	3.68	4.31
Pesona	BUY	0.49	0.70
Protasco	HOLD	1.11	1.14

Highlights

- **2018 to see flattish spending but…** Development expenditure for 2018 has been set at RM46bn (+0.2% YoY). Despite being flattish YoY, this is still the highest posted in the past 6 years. This should help to sustain nominal construction output given its strong correlation (71%) to development expenditure.
- **…potential to pick up later on.** 11MP (2016-2020) has an allocation of RM260bn, 13% higher than 10MP. Subtracting the RM134bn for 2016-2018 leaves RM126bn to be spent for the remaining 2 years (i.e. 2019-2020). Assuming this is spread equally over 2 years, this equates to RM63bn p.a., a strong potential jump of 37% from 2018.
- **Healthy financing flows.** Loan disbursement and approvals to the construction sector grew 13% and 20% YoY (as of Oct 2017), indicating that financing continues to be available.
- **Outperformance to resume.** Real construction growth has outperformed overall GDP since 1Q17. This magnitude diminished in 2017 with real construction growth at 6% (GDP: 5.8%) due to a high base effect and timing gap for mega projects. However, we expect this outperformance to resume in 2018 with real construction growth at 9% on back of an overall GDP of 5.3%.
- **Contract flows to sustain.** Domestic contract awards to listed contractors totalled RM29bn for 2017. While this was a 48% YoY decline (due to the exceptionally high base in 2016), it was still the 2nd highest sum recorded since 2009. We believe the momentum should be sustained YoY for 2018 and target RM25-30bn for the year.
- **Mega jobs on the cards.** We have identified RM168bn worth of mega projects that will be rolled out over the next 1-2 years. In our view, the ECRL (RM55bn) and Pan Borneo Sabah (RM13bn) should take off this year while the HSR (RM60bn) and MRT3 (RM40bn) will be implemented in 2019. While some of the projects will be led by foreigners, we have estimated the overall local content of these projects to stand at RM85bn (51% of project value).

Risks

- The key risks are a soft domestic property market and heightened competition from foreign contractors.

Rating / Valuation

Maintain OVERWEIGHT

- We retain our OVERWEIGHT rating on the construction sector premised on the continued robust flows of jobs. Furthermore, most contractors are already sitting on record high orderbook from strong job wins in the past 2 years.

Top Picks

- Our top picks are centred on the rail theme - **Gamuda (BUY, TP: RM5.95)** and **GKent (BUY, TP: RM4.31)**. We also like **WCT (BUY, TP: RM2.29)** for its earnings revival as driven by its new management team.

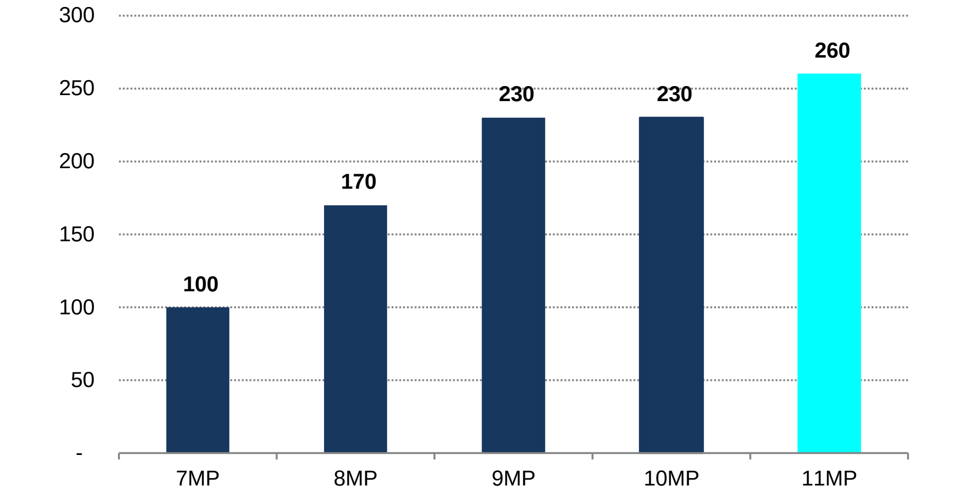
Highlights

Medium term outlook appears favourable

2018 will be the mid-point mark for 11MP.

Mid-point mark for 11MP. 2018 is the mid-point mark for the 11MP which spans from 2016 to 2020. Arguably, this will be the most important Malaysia Plan as it ends in 2020, the target timeline for the country to achieve a “high income nation” status as envisaged under its goal of Vision 2020. For the 11MP, an allocation of RM260bn has been set, representing a 13% increase from the 10MP. This we believe should help to sustain contract flows over the medium term.

Figure #1 Allocation under past Malaysia Plans (RM bn)

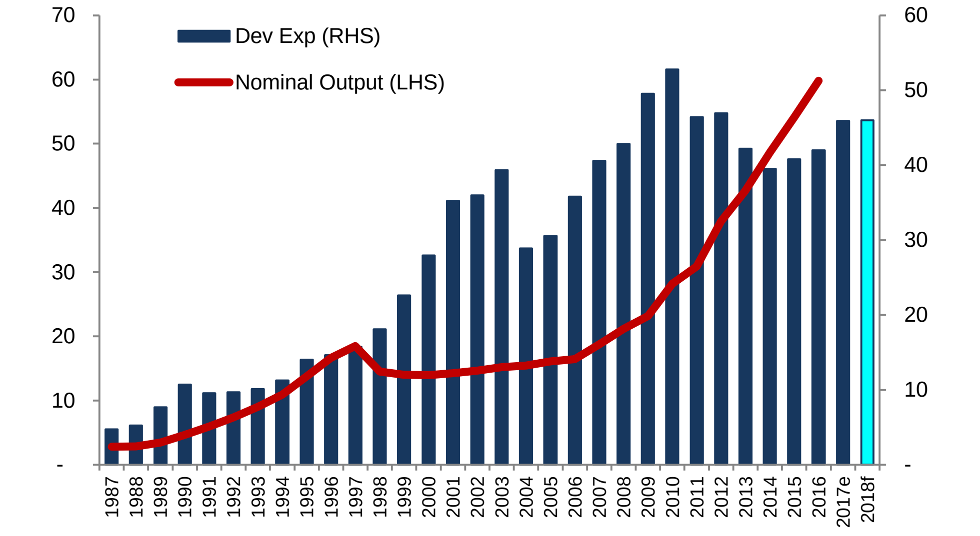


11MP and past MP blueprints

Flattish spending for 2018 but still highest in past 6 years.

Spending stays flat for 2018 but... As depicted below, nominal construction output (i.e. ringgit value of construction work) is correlated to development expenditure at 71%. For 2018, development expenditure has been set at RM46bn (+0.2% YoY). Although this appears flat YoY, this sum is still the highest posted in the past 6 years.

Figure #2 Nominal construction GDP and DE (RM bn)

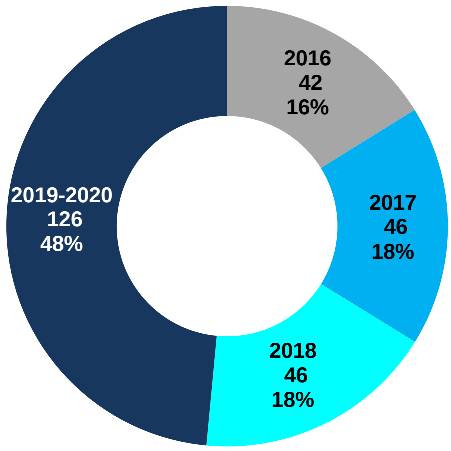


Bank Negara Malaysia, Budget 2018

Ramp up in DE possible from 2019 onwards.

...eventual ramp up possible. Development expenditure for 2016-2018 totals RM134bn. This implies a balance RM126bn to be spent for the remaining 2 years (i.e. 2019 and 2020) of the 11MP. Assuming the remaining sum is spread equally over the last 2 years, this equates to RM63bn p.a., a strong potential jump of 37% from 2018.

Figure #3 Allocation under 11MP (RM bn)

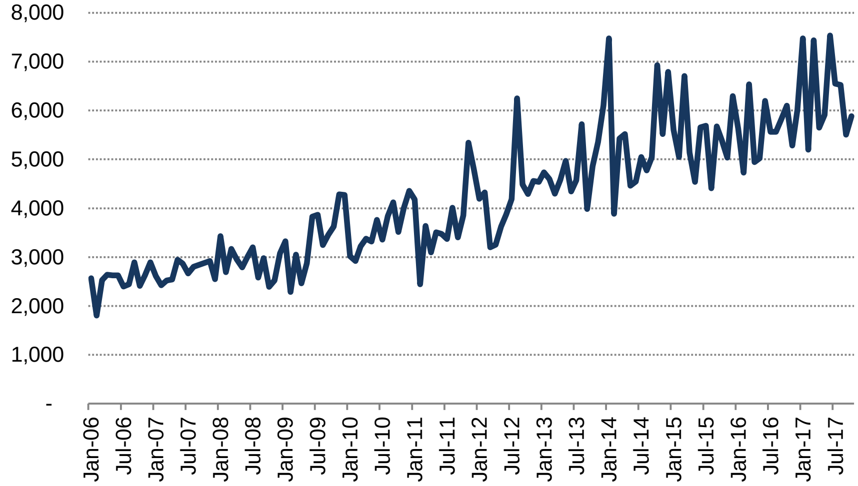


11MP, Budget 2016-2018

Healthy financing flows. The level of construction activity continued to remain robust with total loans disbursed to the sector at RM63.7bn for 2017 (as of Oct), increasing 13% YoY. On the other hand, loan approval to the construction sector rose 20% YoY to RM25.8bn for 2017 (as of Oct). We view this as a positive sign that debt financing continues to remain available for contractors.

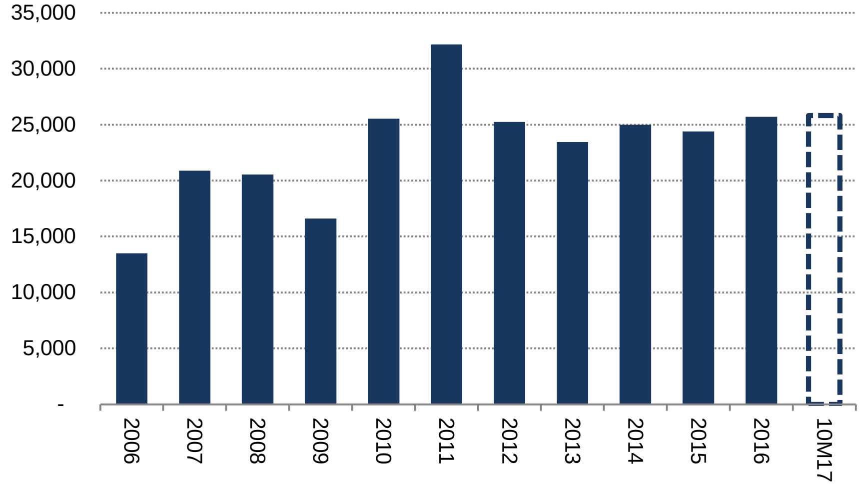
Financing flows to construction has been healthy.

Figure #4 Loans disbursed to the construction sector (RM m)



Bank Negara Malaysia

Figure #5 Loans approved to the construction sector (RM m)



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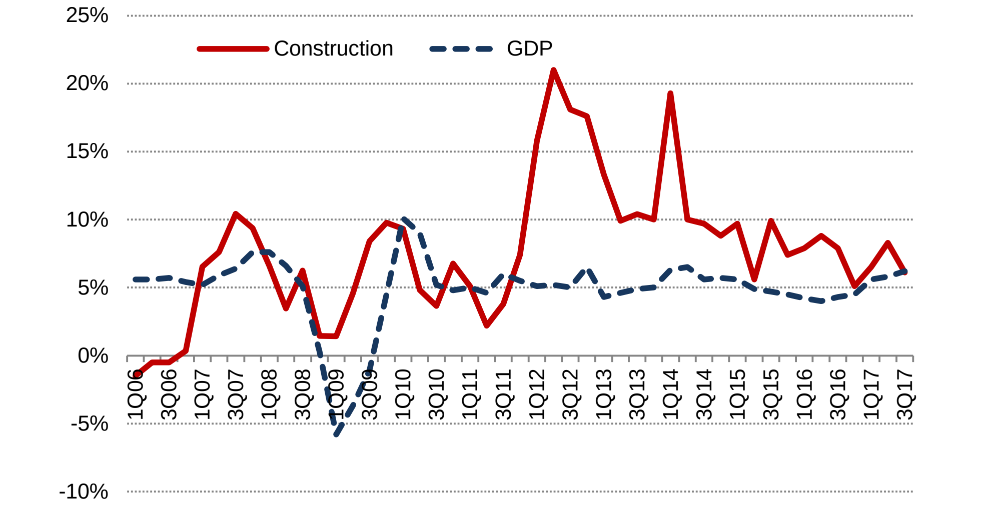
Outperformance to regain momentum. Fuelled by the implementation of various projects under the Economic Transformation Program (ETP), real construction growth has outperformed overall GDP since 1Q12. However for 2017, this magnitude of outperformance diminished due to (i) higher base effect; and (ii) most of the previous mega construction jobs being completed (e.g. MRT1) while the newer ones have yet to gain significant traction (e.g. MRT2, Pan Borneo Highway Sarawak). As such, our economics team is projecting 2017 real construction growth of 6% vs overall GDP expansion at 5.8%. Looking into 2018, our forecast is for construction outperformance to resume with real growth of 9% against an overall GDP backdrop of 5.3%.

Although construction outperformance diminished in 2017, this should resume in 2018.

Figure #6 Real construction output vs GDP (% chg YoY)



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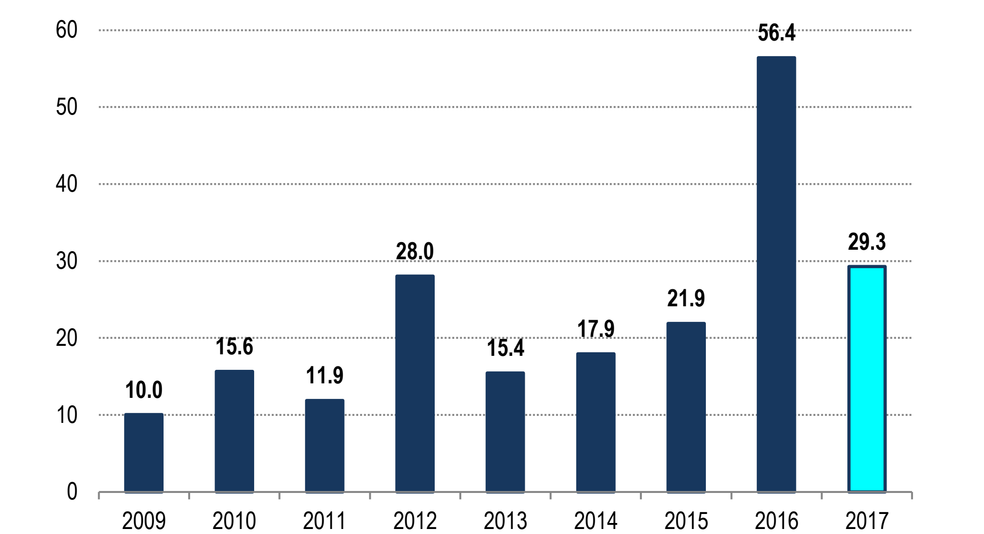
Contract flows to sustain

Still strong despite YoY decline. Based on our tracking of domestic contract awards to listed contractors, the sum for 2017 came in at RM29.3bn. Although this represented a 48% YoY decline, this amount is still the 2nd highest in the past 9 years. The YoY decline for 2017 was certainly anticipated given the significantly higher base posted for 2016 which resulted from major contracts such as the MRT2 and Pan Borneo Sarawak. Major contributors towards job wins in 2017 were the LRT3 (RM7.3bn) and balance contracts for MRT2 (RM3.4bn).

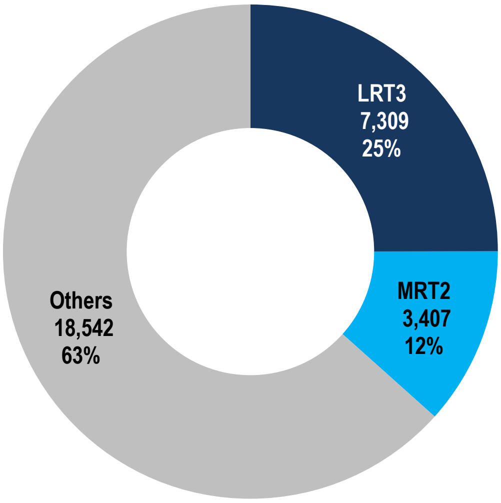
Contract awards for 2017 were the 2nd highest in the past 9 years.

Figure #7 Domestic contract awards to listed contractors (RM bn)



HLIB compilation from Bursa announcements

Figure #8 Domestic contract awards breakdown for 2017 (RM bn)



HLIB compilation from Bursa announcements

RM85bn worth of local works from mega projects on the cards.

Contract flows to sustain this year. For 2018, we expect the momentum of contract awards to be sustained YoY. This should be supported by jobs such as the ECRL (RM55bn), Pan Borneo Sabah (RM13bn) and remaining packages of LRT3. As for the other mega rail projects such as the HSR (RM60bn) and MRT3 (RM40bn), we reckon it is likely that contracts will only start flowing in 2019, although news flow is likely to pick up in 2018. While some of these jobs may be led by foreigners (e.g. ECRL and MRT3), the amount that has been allocated for locals remains sizable. We estimate that this should present local contractors with RM85bn worth of jobs to undertake over the next 1-2 years.

Figure #9 Upcoming mega projects in the next 1-2 years

Project	Value (RM bn)	Local content %	Local content (RM bn)
East Coast Rail Link	55.0	30%	16.5
Pan Borneo Highway, Sabah	12.6	100%	12.6
KL Singapore High Speed Rail	60.0	60%	36.0
MRT3	40.0	50%	20.0
Total	**167.6**		**85.1**

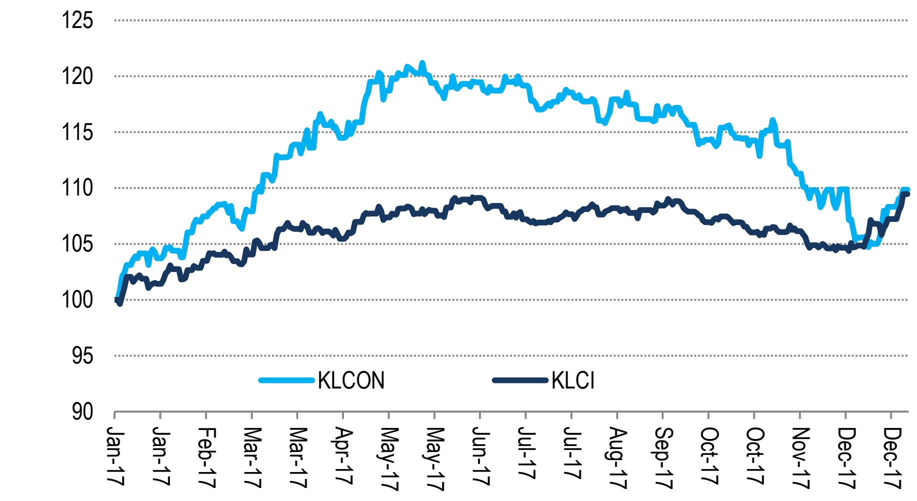
HLIB estimates

Valuation & Rating

KLCON performed on par with FBMKLCI for 2017.

Early outperformance in 2017 dissipated. To recap for 2017, the KLCON was off to a good start, increasing as much at 21.2% and outperforming the FBMKLCI by 13.1% by May. However, this outperformance eventually dissipated in 2H driven by several factors such as (i) higher steel prices; (ii) IJM's removal from the FBMKLCI; and (iii) abolishment of the PDP role for MRT3 which weighed down on Gamuda's share price. Overall, the KLCON ended the year with a 9.8% appreciation, almost similar to that of the FBMKLCI at 9.4%.

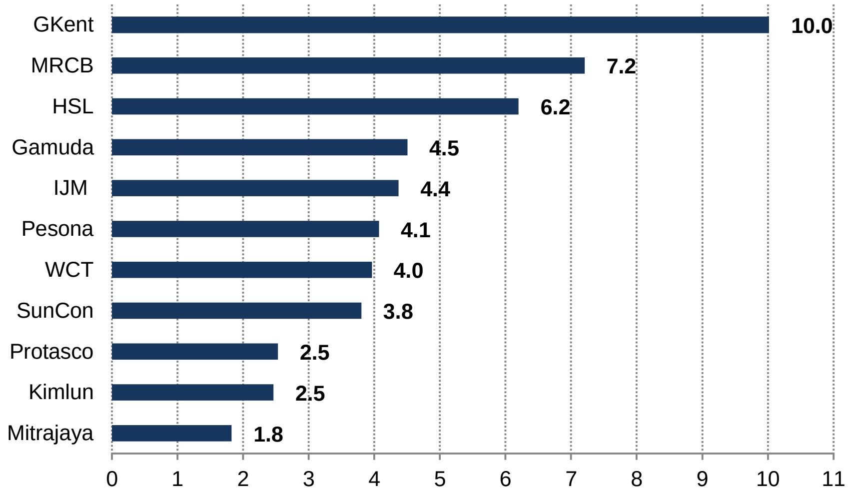
Figure #10 KLCON and KLCI relative performance for 2017



Bloomberg

Maintain OVERWEIGHT for 2018. We retain our OVERWEIGHT stance on contractors for 2018 premised on the continued robust flows of contract awards. Furthermore, most contactors under our coverage are currently sitting on record high orderbook thanks to strong job flows in the past 2 years.

Figure #11 Orderbook cover ratio comparison



HLIB estimates

Stock Picks

Changes to calls and TP

- **MRCB (HOLD↓, TP: RM1.26↑).** We raise our SOP based TP from RM1.18 to RM1.26 after ascribing a higher P/E multiple of 15x (from 12x) to reflect its recovering construction division, higher contribution from PDP fees (mainly LRT3) and perception as an election play. However, we downgrade our rating from Buy to HOLD given its 18% share price run since Dec 2017.

- **SunCon (BUY←→, TP: RM2.85↑).** Our TP for SunCon is raised from RM2.59 to RM2.85 as we tag a higher P/E multiple of 22x to FY18 earnings (20x previously). While our applied P/E target is 1.5 SD above mean, we reckon that this can be justified given its (i) healthy balance sheet with net cash position of RM0.25/share; (ii) superior ROE of 27%; (iii) record job wins and an all-time high orderbook; and (iv) scarcity of pure construction plays.

- **GKent (BUY←→, TP: RM4.31↑).** We raise our SOP based TP from RM3.90 to RM4.31 as we ascribe a higher P/E multiple of 18x (previously 16x) to FY19 (Jan) earnings. The increase in our applied P/E target stems from (i) healthy balance sheet with net cash of RM0.68/share; (ii) strong ROE of 24%; (iii) scarcity premium for being the only local listed contractor with expertise in rail systems; and (iv) perception as an election play.

Top picks for the sector

For the large caps, **Gamuda (BUY, TP: RM5.95)** remains our top pick as it is set to witness a multiyear earnings upcycle (3 year CAGR: 13.7%). Over the near term, earnings will be driven by the MRT2 where the MMC-Gamuda JV is undertaking both the tunnelling (RM15.5bn) and PDP role (RM16.5bn). Looking forward, we see ample opportunity for Gamuda to participate in the several upcoming mega rail projects. For the HSR, Gamuda has formed a JV with MRCB to bid for the PDP role (RM35-40bn) whereby tenders will close by the end of this month. We also see potential for Gamuda to undertake subcontracting roles for jobs such as the MRT3 (RM40bn) and ECRL (RM55bn) given its strong track record in rail jobs. It is also a post 14GE play which could see revival of developments for the Selangor water saga (disposal of SPLASH) and Penang Transport Masterplan.

Within the mid-small cap space, we like **George Kent (BUY, TP: RM4.31)** as a key rail play with exposure to the LRT ext, LRT3 and MRT2. Being the only local contractor with rail systems experience, we believe GKent is in a polar position to participate in the upcoming mega rail jobs. Its financials are also solid with 3-year earnings CAGR of 12% with above industry ROE and net cash position. We also like **WCT (BUY, TP: RM2.29)** which is poised to deliver strong earnings recovery and de-gearing efforts as brought forth by its new management team. It also has a significant amount of surplus land value (i.e. market value less BV) forming >65% of its market cap.

Figure #12 Peer comparison

Stock	Mkt Cap (RM m)	Price (RM)	Target (RM)	Rating	FYE	P/E		P/B		ROE (CY18)	Yield (CY18)
						CY17	CY18	CY17	CY18		
Gamuda	12,426	5.06	5.95	BUY	July	16.9	15.1	1.6	1.5	10.4%	2.7%
IJM	10,305	2.84	3.97	BUY	Mar	19.0	16.3	1.1	1.0	6.4%	3.1%
WCT	2,392	1.70	2.29	BUY	Dec	16.6	14.9	0.8	0.8	5.5%	1.7%
MRCB	5,483	1.25	1.26	HOLD	Dec	77.5	59.8	1.1	1.0	1.8%	0.5%
SunCon	3,334	2.58	2.85	BUY	Dec	23.6	19.9	5.9	5.2	27.6%	2.5%
Kimlun	737	2.30	2.65	BUY	Dec	11.5	9.5	1.2	1.1	12.4%	2.1%
Hock Seng Lee	808	1.47	1.48	HOLD	Dec	17.1	11.7	1.1	1.0	9.1%	2.1%
Mitrajaya	651	0.95	1.15	BUY	Dec	9.7	8.2	1.0	0.9	11.2%	4.3%
GKent	2,073	3.68	4.31	BUY	Jan	20.4	18.3	4.6	4.1	23.7%	2.7%
Pesona	337	0.49	0.70	BUY	Dec	13.8	9.4	2.2	2.0	22.1%	6.2%
Protasco	471	1.11	1.14	HOLD	Dec	15.4	11.7	1.2	1.1	9.8%	6.0%

HLIB estimates

For companies with non-Dec FYE, financials have been calendarised.

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Equity rating definitions

BUY	Positive recommendation of stock under coverage. Expected absolute return of more than +10% over 12-months, with low risk of sustained downside.
TRADING BUY	Positive recommendation of stock not under coverage. Expected absolute return of more than +10% over 6-months. Situational or arbitrage trading opportunity.
HOLD	Neutral recommendation of stock under coverage. Expected absolute return between -10% and +10% over 12-months, with low risk of sustained downside.
TRADING SELL	Negative recommendation of stock not under coverage. Expected absolute return of less than -10% over 6-months. Situational or arbitrage trading opportunity.
SELL	Negative recommendation of stock under coverage. High risk of negative absolute return of more than -10% over 12-months.
NOT RATED	No research coverage and report is intended purely for informational purposes.

Industry rating definitions

OVERWEIGHT	The sector, based on weighted market capitalization, is expected to have absolute return of more than +5% over 12-months.
NEUTRAL	The sector, based on weighted market capitalization, is expected to have absolute return between –5% and +5% over 12-months.
UNDERWEIGHT	The sector, based on weighted market capitalization, is expected to have absolute return of less than –5% over 12-months.