

Outthink. Outperform.

Waiting for the other shoe to drop

The outlook for the Construction sector remains challenging as the federal government is reviewing ongoing infrastructure projects to reduce costs by 20-33%. Projects that could be affected include the Klang Valley MRT Line 2 (MRT2) and LRT Line 3 (LRT3), Pan Borneo Highway (PBH) and Gemas-Johor Bahru Electrified Double Tracking (EDT). There are opportunities in state government projects in Penang and Sarawak. Maintain our NEUTRAL call. Top BUYs are IJM, Suncon and HSS.

Potential MRT2 cost cuts

We gather that the MRT2 project could see a 25% reduction in cost to RM24bn from an initial estimate of RM32bn. The MMC Gamuda Joint Venture (JV) will be the most affected as it is the main contractor for the underground section and the Project Delivery Partner (PDP) for the above-ground section of the MRT2. Other listed contractors that could be affected due to ongoing work on above-ground packages secured include Ahmad Zaki, Gadang, George Kent, IJM Corp, MRCB, MTD ACPI, Mudajaya, SunCon, TRC, TSR and WCT. Since the cost reductions will come from the reduction in the scope of works, we believe only the contract values will be reduced while profit margins should be preserved.

LRT3 costs to be slashed

We gather that the LRT3 construction cost could be slashed to RM9-10bn from an initial estimate of RM15-16bn. The MRCB-George Kent JV will be most affected as the PDP for the project. We maintain our forecasts for MRCB as we believe we were conservative in our contract value assumption at RM9bn for the LRT3 despite the previous escalation in cost. Other contractors affected include AQRS, IJM Corp, SunCon and WCT.

State government-financed projects

The Penang and Sarawak state governments are looking to improve road and public transport infrastructure in their respective states. The Sarawak state government plans to complete the upgrading of the Coastal Highway and trunk roads at an estimated cost of RM11bn. Project pre-qualification bids have been called. Potential Sarawak beneficiaries are Cahya Mata Sarawak (CMS) and Hock Seng Lee (HSL). The Penang Transport Master Plan (PTMP) is pending approval by federal government authorities to be implemented and public feedback collection is ongoing. The Pan Island Link 1 (PIL1) highway and George Town-Bayan Lepas Airport LRT is estimated to cost RM16bn. The Gamuda-led SRS Consortium is the PDP for the project.

Maintain NEUTRAL call

We reiterate our NEUTRAL call on the Construction sector as we remain cautious on the sector due to the risk of order book reductions with potential cost cuts for infrastructure projects. However, we believe the concerns are reflected in current share prices. Our top BUYs are IJM (large-cap), Suncon (mid-cap) and HSS (small-cap). Key upside risk is an acceleration in public infrastructure spending and the key downside risk is further cuts in spending.

Construction peer comparison

Company Name	Rating	Share Pr (RM)	TP (RM)	Mkt Cap (RMm)	Year end	Core PE (x)		Core EPS growth (%)		EV/EBITDA (x)	P/BV (x)	ROE (%)	Div Yield (%)	Sh Pr discount to RNAV	
						CY18E	CY19E	CY18E	CY19E						
IJM CORP	BUY	1.79	2.45	6.5	Mar	14.1	12.5	10.4	12.5	10.2	0.6	4.3	4.4	2.82	37
GAMUDA	HOLD	3.33	3.46	8.2	Jul	12.4	13.1	2.1	(5.7)	12.5	1.1	9.9	3.6	4.36	24
MRCB	BUY	0.70	0.88	3.1	Dec	14.1	9.4	8.1	48.8	15.5	0.6	9.7	2.5	1.56	55
WCT	HOLD	0.89	0.92	1.2	Dec	7.8	7.5	20.7	4.0	14.8	0.4	4.8	3.4	1.70	48
SUNWAY CONSTRUCTION	BUY	1.81	2.45	2.3	Dec	14.5	12.5	19.0	16.1	8.1	3.7	25.8	3.9	2.72	33
GABUNGAN AQRS	BUY	1.03	1.60	0.5	Dec	9.1	6.0	58.5	52.2	5.2	1.2	17.5	2.9	2.12	51
WZ SATU	HOLD	0.31	0.30	0.2	Aug	39.3	9.5	(66.0)	>100	10.6	0.5	0.9	6.6	0.50	39
PINTARAS	HOLD	2.43	2.41	0.4	Jun	19.0	11.1	(10.5)	58.5	6.3	1.3	6.7	8.2	NA	NA
HSS ENGINEERING	BUY	0.94	1.18	0.5	Dec	19.9	18.4	1.6	8.5	11.5	1.6	7.9	2.5	NA	NA
Average				22.9		12.2	11.0	8.2	11.7	11.7	1.2	6.4	4.2		38

Source: Bloomberg, Affin Hwang forecasts

Note: Pricing as of close on 3 Oct 2018

Affin Hwang Investment Bank Bhd (14389-U)

Sector Update

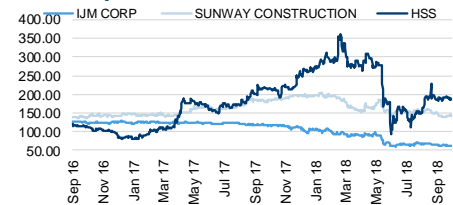
Construction

Neutral (maintain)

Absolute Performance (%)

	1M	3M	12M
AQRS	(6.4)	(14.9)	(37.9)
Gamuda	(10.0)	2.8	(37.1)
HSS Eng	2.2	33.3	(9.5)
IJM Corp	(6.3)	1.7	(45.9)
MRCB	0.7	15.8	(23.2)
Suncon	(0.4)	(6.5)	(37.4)
WCT	(3.7)	1.1	(19.9)
Pintaras	4.7	9.3	(48.8)
WZ Satu	-	3.4	(62.3)

Relative Performance to KLCI (%) – IJM Corp, Suncon, HSS



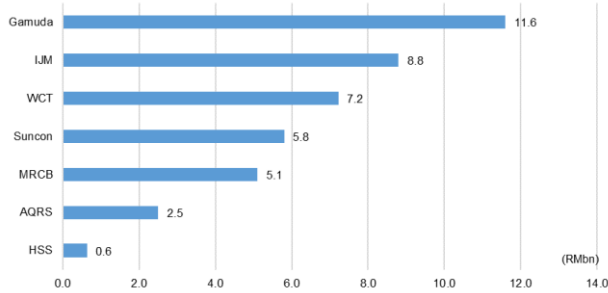
Source: Affin Hwang, Bloomberg

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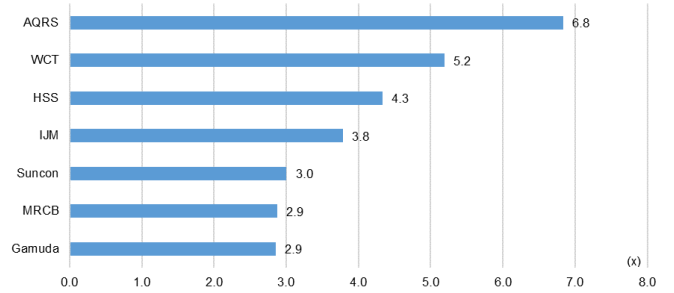
Key focus charts

Fig 1: Construction order book at end-1Q18



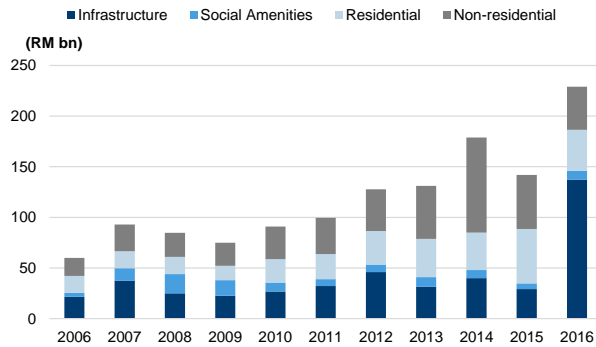
Source: Company, Affin Hwang estimates

Fig 2: Order book/revenue at end-1Q18



Source: Company, Affin Hwang estimates

Fig 3: Annual contract awards by type of project



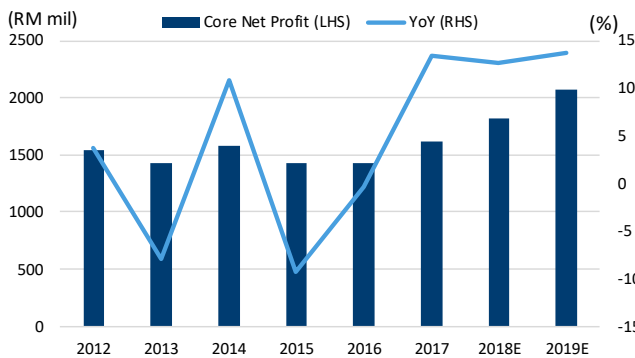
Source: CIDB

Fig 4: Infrastructure works to be awarded in 2019 onwards

Project	Cost (RMbn)
Penang Transport Master Plan (PTMP)	32
Pan Borneo Highway Sabah (PBH)	13
Sarawak Coastal Highway and truck roads	11
Klang Valley Double Tracking	5
Total	61

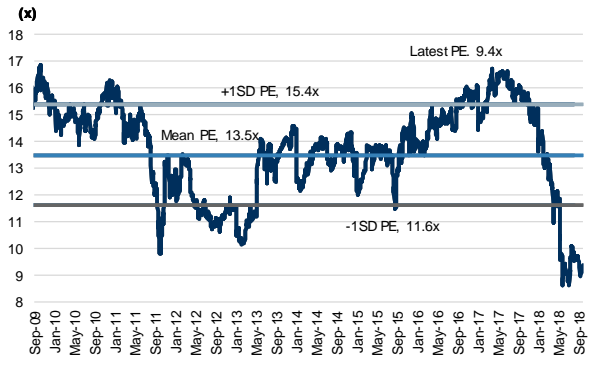
Source: Affin Hwang estimates, various media sources

Fig 5: Aggregate construction core net profit and yoy change



Source: Affin Hwang estimates

Fig 6: KL Construction Index 12-month forward PER



Source: Bloomberg

Potential MRT2 cost cuts

We understand that state-owned MRT Corp is negotiating with the MMC Gamuda JV to reduce the cost of the MRT2 project and convert the latter's PDP contract to a turnkey construction contract based on a fixed lump-sum value. Indications are the cost will be reduced to RM24bn from the initial estimate of RM32bn. To date, 98% of the total project works with value of RM31bn has been awarded for the MRT2. The reduction in the scope of works, including the removal of several stations such as the two stations in Bandar Malaysia, are being finalized between the MMC Gamuda JV and the work package contractors.

Fig 7: MRT2 work packages awarded to contractors

Award date	Project	Contractor	Value (RMm)
Klang Valley Mass Rapid Transit Line 2 (Sg Buloh-Serdang-Putrajaya Line)			
Apr-16	KVMRT Line 2 Package V201 (Sg Buloh-Persiaran Dagang)	Sunway Construction	1,213
Mar-16	KVMRT Line 2 Package V202 (Persiaran Dagang-Jinjang)	Ahmad Zaki	1,440
May-16	KVMRT Line 2 Package SY203 (electric trains and depot equipment)	HAP Consortium	1,620
Mar-16	KVMRT Line 2 Package SBG201 (box girders for V201-V205)	SPC Industries Sdn Bhd	199
Mar-16	KVMRT Line 2 Package SBG202 (box girders for V206-V210)	Acre Works Sdn Bhd	170
Mar-16	KVMRT Line 2 Underground Work Package	MMC-Gamuda	15,470
May-16	KVMRT Line 2 Package SY201 (signal and train control system)	Bombardier-Global Rail	458
May-16	KVMRT Line 2 Package V210 (Persiaran APEC-Putrajaya Sentral)	MRCB	648
May-16	KVMRT Line 2 Package V203 (Jinjang-Jln Ipoh)	IJM Corp	1,470
May-16	Package DPT 203: Serdang depot	TSR Capital	90
Aug-16	KVMRT Line 2 Package SSP-SY-204 (System Work Package)	George Kent - CCCC (49:51)	1,007
Aug-16	KVMRT Line 2 Package V202 (Relocation of telecommunication works)	UEM Edgenta	87
Nov-16	KVMRT Line 2 Package V204 (Bandar Malaysia's south portal to Kampung Muhibbah)	WCT Holdings	896
Nov-16	KVMRT Line 2 Package V208 (Taman Pinggiran Putra to Persiaran Alpina)	MTD Construction Sdn Bhd	679
Dec-16	KVMRT Line 2 Package V207(Universiti Putra Malaysia to Taman Pinggiran Putra)	Mudajaya Group Berhad	559
Mar-17	KVMRT Line 2 Package V206 (Serdang-UPM)	Gadang	952
Mar-17	KVMRT Line 2 Package V209 (Persiaran Alpina-Persiaran APEC)	Acre Works Sdn Bhd	716
Mar-17	KVMRT Line 2 Package V205 (Kg Muhibbah-Serdang Jaya)	TRC Synergy	858
Mar-17	Elevated stations and other associated works in Damansara Damai, Sri Damansara West and Sri Damansara East	Sunway Construction	212
Dec-17	KVMRT2 Package V201 to V210: design, supply, installation, testing and commissioning of noise barriers and enclosures	Muhibbah Engineering	189
Total			28,934

Source: MRT Corp, Bursa Malaysia, various media sources

LRT3 costs to be slashed

We gather that the MRCB-George Kent JV is also negotiating with state-owned Prasarana Nasional to reduce the cost of the LRT3. We gather that the initial estimate of the construction cost for the project was RM9bn and the land acquisition cost was RM1bn. The cost increased to RM15bn as the scope of works was increased by Prasarana due to additional features including the use of six-car train sets instead of three-car train sets. Other cost-cutting measures include the cancellation of the 2km underground section awarded to IJM Corp and the shelving of 5 stations with low projected passengers.

We understand that the government wants the JV to reduce the construction cost of the LRT3 project back to the original estimate of RM9bn with the reduction in the scope of works. The PDP fee at 6% of project cost will likely be changed to a fixed-fee contract. Based on the initial cost of RM9bn, MRCB's 50% share of the PDP fee is RM270m for the LRT3. The completion of the project will be delayed to 2024 from 2020 to reduce the cost by not implementing the project on a "fast track" basis. Negotiations with the work package contractors are ongoing to reduce the cost. Some of the contractors affected are Gabungan AQRS, IJM Corp, Mudajaya, SunCon and WCT.

Fig 8: LRT3 work packages awarded to contractors

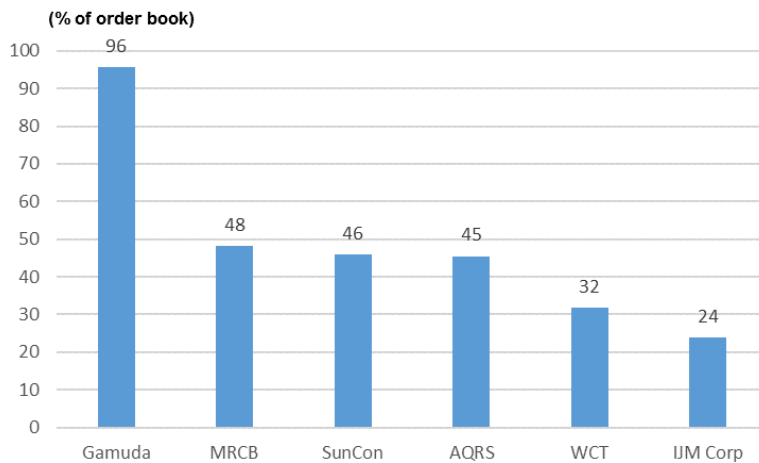
Award date	Company	Value (RMm)	Package	Works
Apr-17	TRC Synergy	761	TD2	Construction and completion of the Johan Setia depot (Phase 2)
Apr-17	WCT Holdings Sdn Bhd	186	TD1	Build Johan Setia depot and associated works
Apr-17	Mudajaya Group Bhd	58	PC2	Manufacture, supply and delivery of precast pier caps and other related works
Aug-17	CRRRC Zhuzhou Locomotive Co Ltd-Siemens Ltd China-Tegap Dinamik Sdn Bhd Consortium	1,600	NA	Design, manufacture, supply, delivery, installation, testing and commissioning of 42 six-car LRVs for LRT3
Aug-17	WCT Holdings Sdn Bhd	840	GS03	Construction and completion of the guideways, stations, park and ride, ancillary buildings and other associated works
Oct-17	Sunway Construction	2,309	GS07-08	Construction and completion of the guideways, stations, iconic bridge, park and rides, ancillary buildings and other associated works
Oct-17	WCT Holdings Sdn Bhd	640	GS02	Construction and completion of the guideways, stations, park and ride, ancillary buildings and other associated works
Oct-17	Gabungan AQRS	1,206	GS04	Construction and completion of the guideways, stations, park and ride, ancillary buildings and other associated works
Oct-17	Mudajaya Group Bhd	1,160	GS01	Construction and completion of the guideways, stations, park and ride, ancillary buildings and other associated works
Nov-17	Econpile Holdings Bhd	209	GS04	Bored piling and general infrastructure works under the package GS04
Feb-18	EITA Resources Bhd	81	GS01-05	Supply, delivery, installation, testing and commissioning of escalators
Mar-18	EITA Resources Bhd	71	GS06-10	Supply, delivery, installation, testing and commissioning of escalators
Mar-18	EITA Resources Bhd	56	GS01-10, TD2	Supply, delivery, installation, testing and commissioning of lifts
Mar-18	IJM Corporation	1,116	Underground	Design and construction of uderground tunnel, stations, ancillary buildings and other associated works.
Mar-18	Muhibbah Engineering (via 49% owned JV)	33	NA	Design, supply, delivery installation, testing and commissioning of noise barrier for Package NBE (W)
Total		10,323		

Source: Prasarana, Bursa Malaysia, various media sources

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For the construction companies under our coverage, Gamuda has the highest exposure to the MRT2 and LRT3 projects based on their outstanding order books. Others with high exposure are MRCB, SunCon and AQRS. There is downside risk to earnings forecasts for the work package contractors due to the potential reduction in contract values.

Fig 9: Exposure of construction company order books to MRT2 and LRT3

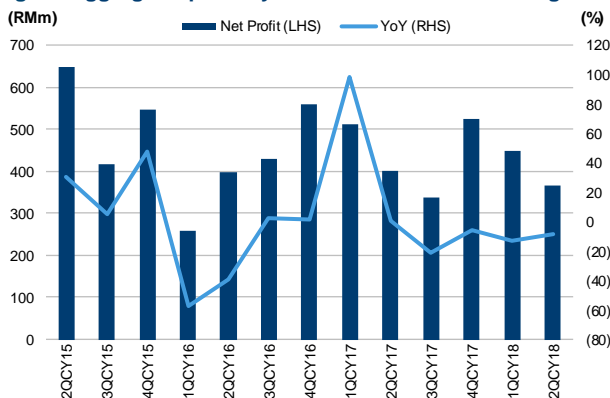


Source: Company, Affin Hwang estimates

2Q18 earnings were mostly below expectations but still growing

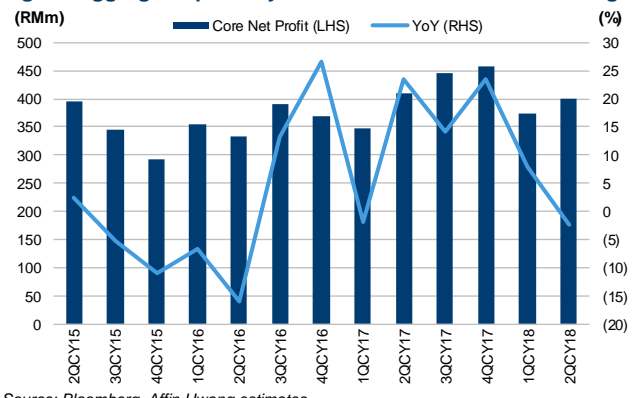
Construction companies reported mixed results in 2Q18. Only 1 firm was above expectations, namely AQRS, 3 were within expectations, namely GAM, HSS and WCTHG, while 5 were below expectations, namely IJM, PINT, MRC, SCGB and WENG. In terms of core earnings growth, 5 companies reported better results yoy, while 4 saw yoy contractions. Overall, core earnings grew 6% yoy. Those with property arms saw mixed results with IJM and WCT reporting better property earnings, while AQRS, GAM and MRC showed weaker property earnings. Most saw slower sales and progress billings due to general-election uncertainties. Construction earnings for most companies showed positive growth momentum with good progress for major infrastructure projects such as the MRT2.

Fig 10: Aggregate quarterly construction sector earnings



Source: Bloomberg, Affin Hwang estimates

Fig 11: Aggregate quarterly construction sector core earnings



Source: Bloomberg, Affin Hwang estimates

State government-financed projects

The Gamuda-led SRS Consortium is working on getting approvals from the Department of Environment and Ministry of Transport in order to sign the detailed PDP agreement with the Penang state government for the PTMP project by end-2018. Upon receiving the relevant approvals, SRS will proceed with the detailed design works and securing financing for the project in 1H19 and starting construction works in 2H19. It is uncertain if the Penang state government's request for a RM1bn loan from the federal government to part finance the PTMP will be approved. The financial support would allow the PIL1 and Penang LRT to be implemented simultaneously.

Gamuda and HSS are potential beneficiaries of PTMP

Based on the RM16bn cost for the PTMP infrastructure and Gamuda's 60% stake in SRS, the project will potentially lift Gamuda's order book by RM9.6bn or 83% to RM21.2bn from RM11.6bn currently. However, there are financing and execution risks for the project as SRS has to reclaim land worth about RM16bn to finance the infrastructure using proceeds from the sale of land. HSS is a potential beneficiary of detailed design contracts to be awarded for the Penang LRT as it has the competitive advantage of having undertaken the feasibility studies for the project previously.

CMS and HSL are potential beneficiaries of Sarawak road projects

The Sarawak state government is also looking to improve road and public transport infrastructure in the state as the government is reported to have reserves amounting to RM31bn. The Sarawak state government plans to complete the upgrading of the coastal and second trunk road at an estimated cost of RM11bn. Project pre-qualification bids have been called. Potential Sarawak-based company beneficiaries are Cahya Mata Sarawak (CMS), Hock Seng Lee (HSL), Naim Holdings and Zecon. We gather that consortiums led by Sarawak companies, which could include contractors from Peninsular Malaysia or overseas, are also allowed to bid for the project work packages.

Maintain NEUTRAL call

We estimate the potential large-scale infrastructure projects to be implemented from 2019 onwards following the review will be reduced to RM61bn from RM108bn previously. The major change is the exclusion of the RM55bn East Coast Rail Link from our list. The project has been postponed/cancelled by the federal government. We excluded the RM11bn Kuching LRT project as we gather that the state government will re-prioritise its spending to upgrade the road network instead. We believe it is also difficult to get the necessary federal government approval for the project following the regime change.

Top BUYs are IJM, SunCon and HSS

New contract procurement prospects remain challenging for the contractors as the federal government is embarking on an austerity drive and development expenditures are likely to be reduced in the upcoming Budget 2019 announcement on 2 November. We believe the low PER and Price/book valuations (more than 1sd below mean levels) for the construction stocks reflect these current concerns. We reiterate our NEUTRAL call on the Construction sector. Our top BUYs are IJM (large-cap), SunCon (mid-cap) and HSS (small-cap).

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Fig 12: Construction sector peer comparison

Company Name	Rating	Share Pr	TP	Mkt Cap	Year end	Core PE (x)		Core EPS growth (%)		EV/EBITDA (x)	P/BV (x)	ROE (%)	Div Yield (%)	Sh Pr discount to RNAV
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WCT	HOLD	0.89	0.92	1.2	Dec	7.8	7.5	20.7	4.0	14.8	0.4	4.8	3.4	48
SUNWAY CONSTRUCTION	BUY	1.81	2.45	2.3	Dec	14.5	12.5	19.0	16.1	8.1	3.7	25.8	3.9	33
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Average				22.9		12.2	11.0	8.2	11.7	11.7	1.2	6.4	4.2	38

Source: Affin Hwang estimates

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +10% over a 12-month period
HOLD	Total return is expected to be between -5% and +10% over a 12-month period
SELL	Total return is expected to be below -5% over a 12-month period
NOT RATED	Affin Hwang Investment Bank Berhad does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation

The total expected return is defined as the percentage upside/downside to our target price plus the net dividend yield over the next 12 months.

OVERWEIGHT	Industry, as defined by the analyst's coverage universe, is expected to outperform the KLCI benchmark over the next 12 months
NEUTRAL	Industry, as defined by the analyst's coverage universe, is expected to perform inline with the KLCI benchmark over the next 12 months
UNDERWEIGHT	Industry, as defined by the analyst's coverage universe is expected to under-perform the KLCI benchmark over the next 12 months

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