Construction

Sector outlook

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Malaysia

Infrastructure

Change in rating or target:

SunCon	(SCGB MK)
Rec	**BUY (from SELL)**
Market cap	US$0.5bn
Price	RM1.82
Target (old)	**RM1.60**
Target (new)	**RM2.15**
Up/downside	+18%

IJM	(IJM MK)
Rec	**BUY**
Market cap	US$1.9bn
Price	RM2.10
Target (old)	**RM2.05**
Target (new)	**RM2.46**
Up/downside	+17%

Maintain

Gamuda	(GAM MK)
Rec	**SELL**
Market cap	US$1.8bn
Price	RM2.89
Target	RM2.90
Up/downside	0%

Back in play

Expecting east coast rail link to stage a comeback; we turn positive

After several twists and turns, the ECRL project, which has been suspended since July 2018, is back in play, we believe. It was revealed last Friday by ex-finance minister, Tun Daim Zainuddin, who heads the negotiations, that talks are expected to finalise early next month with cost savings of RM10bn, suggesting discussions are advanced. We take the view the ECRL will make a return, and along with it adequate job prospects which causes us to turn positive on the sector emerging from a job prospect lull. We like the risk-reward for IJM which is our sector pick, and we upgrade SunCon from SELL to BUY.

Several factors in combination sees ECRL expected to go ahead

- **Strong signals that negotiations are advanced** as the savings can be quantified at RM10bn (from the originally awarded RM55bn construction cost). The expected date to come to finalised terms is understood to be soon (2 April).
- **It comes down to costs:** We previously viewed the ECRL to be a bonus, if it returns, arguing operating costs of reportedly c.RM1bn annually would still be prohibitive. While critical of the project, Tun Dr Mahathir has said the project could resume if the price is right and if China agrees. We presume proceeding with the project with the cost cuts may still be more palatable than having to pay a termination penalty.
- **Other considerations:** Tun Daim explained there is also a commercial element in the negotiations. We see this as the need to maintain a bilateral relationship with its largest trading partner, & Malaysia's 3rd-largest buyer of palm oil, after India & Europe.

Not much detail on the savings; opportunity boost to the industry sizeable

- While details are lacking on the cost savings, some of the possible ways include laying an electrified single track (initially) on a double track formation to potentially reduce the tunnelling component & to alignment change (although this may alter connectivity).
- The revised deal may also see a larger share of local content, reported to be 40%-50% from 30% previously (the Star paper, 30 Jan). Assuming a 30% scenario of a scaled-down RM45bn, this would amount to a c.RM14bn opportunity and bring cheer to construction and material firms (including the steel players). Margins may, however, be thin for the ECRL and thus favours contractors with strong execution track records.

Nudges us to turn positive on the sector (from Neutral)

- Viewing ECRL will proceed, this presents an inflection point from the job prospect lull, and we increase the PE multiples for the construction segment from our previous trough-cycle multiples. With this change we lift our target price for IJM to RM2.46 (previously RM2.05), and also factoring in a lower holdco discount given three divisions could benefit (construction, industry and potentially ports).
- We revise-up SunCon's construction PE multiple to 15.4x (1 std. over the medium-term industry mean PE) from 11x, lifting our target price to RM2.15 (from RM1.60).
- For Gamuda, which has somewhat of an overhang on the toll road negotiations, our SELL recommendation and RM2.90 target price remain unchanged.

KLCON Index price and PE

Source: CLSA

For important disclosures please refer to page 13.

Government likely to proceed on the right price

According to a previous breakdown by Lim Guan Eng, the ECRL could cost Malaysia RM81 bn (figure 1). Tun Dr Mahathir has stated that the ball is in Beijing's court, and the ECRL is able to proceed at an appropriate scale. The crux of the matter lies in the sum the Malaysian government is able to save.

Could focus on building necessary components first

The quantum of cost cuts would help to justify continuing with the project, even if it is not all clear the potential benefits to the economy for having the ECRL. This will help Malaysia avert a penalty sum (value not disclosed) notwithstanding some monies on this project has been paid (RM10.02 bn in advance payment and RM9.67 bn in progress payment). Thus, we could foresee the construction focusing on what is necessary – this may involve construction of single track first on a double track formation. Alignment changes may also save some money particularly if it can reduce tunnelling costs although these would have to be balanced out with changes in travelling time. Based on last reported progress prior to the suspension, ECRL was at 13% completion.

Sizeable opportunities abound

The 688km line would present multiple opportunities to the construction sector. Phase 1 alone, which excludes the portion from integrated transport terminal, Gombak to Port Klang, has 22 stations. In total, there are multiple tunnels spanning 48.5km in aggregate, the longest of which being a 18km tunnel which would have made it the longest in South East Asia, between Gombak and Bentong. Naturally, all the above may be subject to changes if there are more details about the changes in scope/scale. Additionally, there are a total of 80 bridges, some of which are greater than 300 meters in length.

Figure 1

ECRL: breakdown of costs since original plan

	RM bn	Remark
Nov 2016	46.0	Original cost from integrated transport terminal from Gombak, Selangor to Wakaf Baru in Kelantan
May 2017	1.3	Northern extension from Wakaf Baru to Pengkalan Kubor
May 2017	9.0	ECRL phase 2 - ie from integrated transport terminal, Gombak, to Port Klang
Aug 2017	10.5	Upgrading from single track to double track
Subtotal	66.8	Total cost (construction portion)
	24.6	Land acquisition, interest, fees and other operational costs
Total	80.9	

Source: CLSA, The Edge quoting finance minister, Lim Guan Eng

More cheer for the construction sector if the local content requirement is raised

Looking beyond the cost to the government, a return of ECRL would be a boon to the construction sector that has been hungry for catalyst, ranging from construction firms to materials including steel players. If we assume the scaled down portion of RM10 bn from RM55 bn, this translates to RM45 bn of total works. Assuming a 30% local content (although latest iteration is touted to increase this to 50%), this allows for RM14 bn of opportunities for local firms spread over the next few years. RM14 bn is equivalent to >90% of combined construction revenues for the top 10 construction companies on KLCON index by market cap.

Zooming into potential beneficiaries

More granularly, those that have previously been awarded projects relating to the ECRL would emerge as beneficiaries on order book continuity, such as the RM82.5 mn awarded to HSS Engineers (N-R) to provide supervising consultancy services on infrastructure works as well as Lafarge Malaysia Bhd (N-R) which had previously secured supply of cement valued at RM270 mn to all 8 packages of the project. Additionally, one of the potential beneficiaries would also be Gabungan

AQRS (N-R), where it should have the first right of refusal for construction works on a key station in the state of Pahang, if ECRL materialises.

Link to AQRS non-rated report: *Snoopin around (AQRS - N-R (Bearing fruit))*

Figure 2

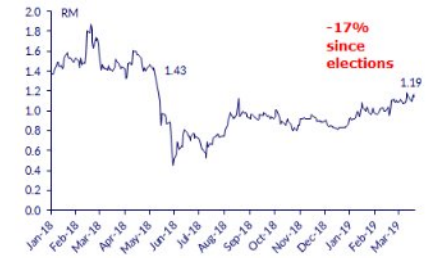
Listed names associated with the ECRL project/expressed interest

Company	Description
HSS Engineers (N-R)	Supervising consultancy services for ECRL
Gabungan AQRS (N-R)	Has first right of refusal for construction in Kota SAS, where a station was to be built
IJM	Eyeing supply of piles, aside station construction work near Kuantan Port
Gamuda	Earlier was in negotiations with CCCC as potential subcontractor to ECRL; has working relationship with CCCC in MRT project
Econpile (N-R)	Potential piling beneficiary; has partnered CCCC in 2 other projects
Lafarge (N-R)	Previously had RM270 mn supply deal for ECRL
WZ Satu, Fajarbaru (N-R) WCT (N-R), SunCon	A selection of companies having previously expressed interest to bid

Source: CLSA, companies

Figure 3

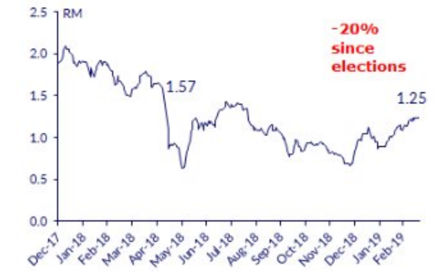
HSS Engineers price



Source: CLSA, Bloomberg

Figure 4

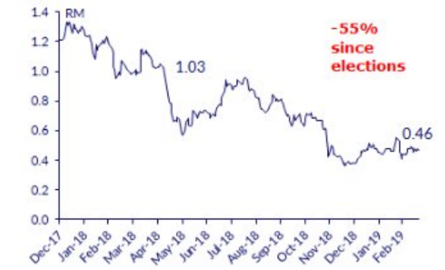
Gabungan AQRS price



Source: CLSA, Bloomberg

Figure 5

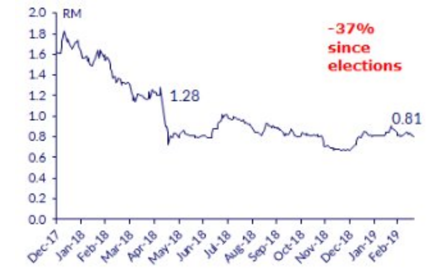
Econpile price



Source: CLSA, Bloomberg

Figure 6

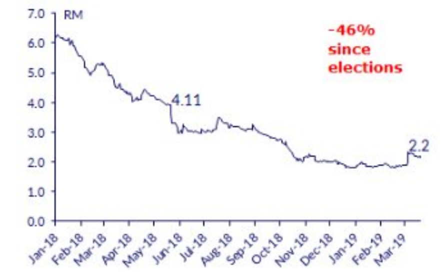
WCT price



Source: CLSA, Bloomberg

Figure 7

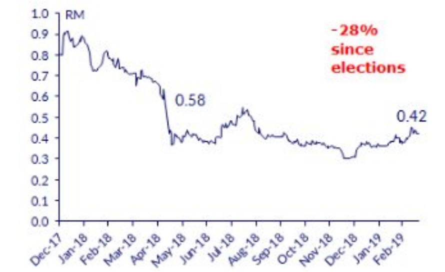
Lafarge price



Source: CLSA, Bloomberg

Figure 8

Fajarbaru price

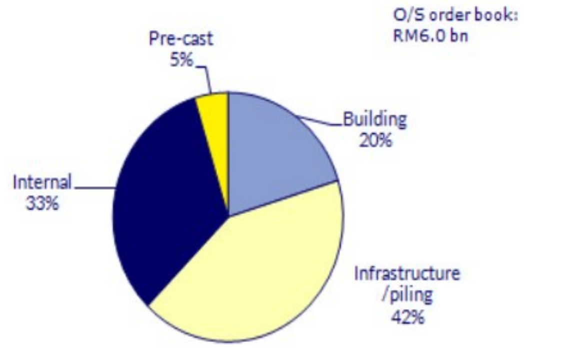


Source: CLSA, Bloomberg

SunCon (BUY) – rerating expectation

Figure 9

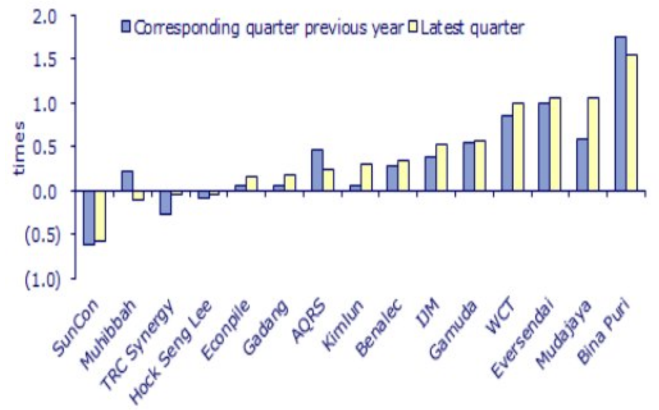
SunCon order-book breakdown – a third supported by internal jobs



Source: CLSA, SunCon

Figure 10

Gearing ratios and YoY change: SunCon has the distinction of a superior balance sheet strength



Source: CLSA, SunCon

A play on ECRL potentially via piling works. Order book wins to date past the half way mark of its guidance

With the resumption of the ECRL, we foresee SunCon likely to be keen to participate, in particular in piling works which are typically more beneficial to margins, aside from being involved in station work, if available. Track works could be also among the prospects. On job flows, SunCon has proven that momentum continues to be healthy, having bagged RM868 mn out of its target of RM1.5 bn for the year so far, ie more than the half way mark.

Target price raised to RM2.15 from RM1.60. Restoring a PE multiple advantage over peers premised on the view its catalysts are better

SunCon has carved a strong niche particularly in the involvement of large-scale transportation projects, having proven its capability of reprising major roles in the rail related projects such as the Bus Rapid Transit (BRT), Light Rapid Transit (LRT), and MRT projects. Post elections in May 2018, the visibility of mega projects was poor and we had lowered its PE multiple to 11x. With the expectation that ECRL is more likely than not to make a return, we think SunCon can shine again and raise its valuations to 1sd above 5 year mean KLCON index PE, to 15.4x. As a result, TP is raised to RM2.15 (from RM1.60).

Solid net cash position

SunCon historically commands some PE premium over the sector which could be attributable to both dependable slew of internal jobs from its parent, Sunway Berhad (N-R), currently a third of its outstanding RM6.0 bn order book. Meanwhile, given its pure-play construction nature, its asset light balance sheet has also allowed it to remain in a net cash position. Assuming its net cash per share of 29 sen were excluded from the target price, the adjusted PE would map to a PE multiple of 13.4x.

The risk to our call would be higher than expected cuts in LRT3 costs which we expect to be 30%

Risk to our call would be the speed of roll-out of the ECRL. Operationally, SunCon's pre-cast segment still remains in the doldrums until the delivery of pre-cast products secured with higher margins kick in. On its LRT3 award, which constitutes close to a-third of outstanding order book, negotiations approach tail end. We now assume a 30% cut in LRT3 order book, which affects trims our earnings by 4% yearly over the forecast horizon, subject to finalisation.

Figure 11

Change in earnings

RM mn	19CL	20CL	21CL
Previous revenue forecast	2,627	2,957	2,859
Revised revenue forecast	2,482	2,811	2,713
Percentage change in revenue	5%	5%	5%
Previous net profit forecast	161	187	174
Revised net profit forecast	154	180	167
Percentage change in net profit	4%	4%	4%

Source: CLSA, SunCon

Figure 12

Calculation of SunCon's target price

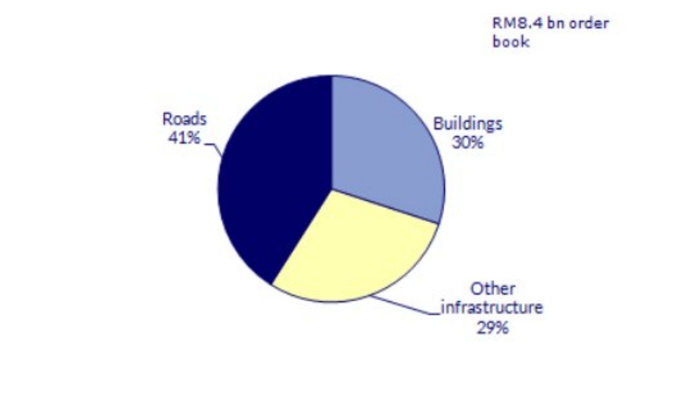
PE method of valuation	Remarks	Value (RM mn)
Earnings (20CL)	15.4x, i.e. PE multiple at 1 sd above 10-year sector mean of 13x	179.9
Multiple applied (15.4x)		15.4
Total		2,770
Number of shares (unit million)		1,293
Price per share (RM)		2.15

Source: CLSA, SunCon

IJM (BUY) – Three-pronged benefit

Figure 13

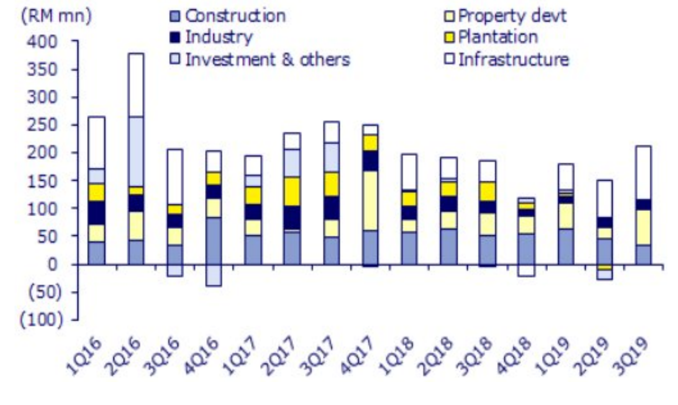
IJM: breakdown of construction order book (Dec 2018)



Source: CLSA, IJM

Figure 14

IJM: breakdown of core pre-tax profit



Source: CLSA, IJM

Three sectors to be a potential beneficiary

IJM's stock price gained some 15% in March 2019, and increase YTD (up to 22nd March) of 30% tops that of a 24% increase in Gamuda. With ECRL coming back in play, this will continue to act as support for the counter, since IJM is likely to see benefits across 3 business areas - construction, industry, and port operations – which in aggregate form 45% of operating profits (EBITDA for 9MFY19).

Lends support to piling the division

Where IJM's business may experience some recovery from the advent of the ECRL would be in its industry division (12% of pre-tax profit), where the bulk of this is contributed from piling. In anticipation of ECRL previously, IJM had prepared to supply piles to the project, including investing in setting up a plant. For the ECRL, piles may be used where there are stretches involving elevation and bridges for example. The ECRL would benefit IJM by way of better utilisation to improve pre-tax profit margins in this division that has dipped to 7%.

Construction opportunities due to proximity

Given the position of 2 stations adjacent to its 60%-owned Kuantan Port (namely Kuantan port city 1 and 2), this suggests that IJM would be in good position as well to bid for the related construction works, to add to its impressive RM8.4 bn order book (Dec 2018). Once ready, cargo movements made possible via the ECRL could also channel more throughput to IJM's 60%-owned Kuantan port although such benefit is hard to quantify at this moment.

Plantations business weighs

The Achilles heel for IJM currently remains the plantation business which is in the red as it stays challenged by a large Indonesia exposure to young palms that have yet to enter prime production age, but incurring full overheads costs, aside from weak CPO prices.

Target price increased to RM2.46 from RM2.05

The main changes to our RNAV per share is restoring construction and concrete products business to 10 year average KLCON index PE at 13.3x from previously 9x reflecting a trough cycle valuations. Given that our central expectation is for ECRL to proceed, we believe this will eventually drive re-rerating for IJM and thus lower the discount to RNAV to 10% (previously 20%).

Figure 15

IJM valuation

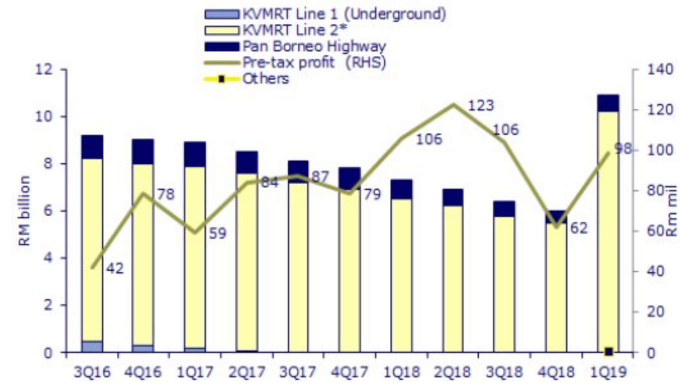
Malaysia (RM mn)	Basis	Revised	Previous	Remark
Construction	13x sustainable profit	1,901	1,378	Restore to 13x sustainable profit from 9 previously
Concrete products (industry)	13x sustainable profit	947	655	Restore to 13x sustainable profit from 9 previously
Besraya concession	DCF	461	461	
New Pantai Expressway concession	DCF	663	663	
Kuantan Port concession	DCF	1,161	1,161	
West Coast Expressway concession	DCF	451	451	
IJM Land	10% haircut to RNAV	4,305	4,305	
IJM Plantations	56% ownership	470	470	18x 2018 net profit
WCE Holdings	26% ownership	138	170	Market value
Scomi Group	21% ownership	13	13	Market value
Overseas concession assets		690	690	
Revised gross asset value (RGAV)		11,199	10,417	
Company level net cash/(debt)		(1,235)	(1,235)	
Revised net asset value (RNAV)		9,964	9,181	
No. of shares		3,636	3,614	
RNAV/share (RM)		2.74	2.54	
Discount		10%	20%	
Target price		2.46	2.05	Reduce discount to 10% from 20% previously

Source: CLSA, IJM

Gamuda (SELL) – staying interested

Figure 16

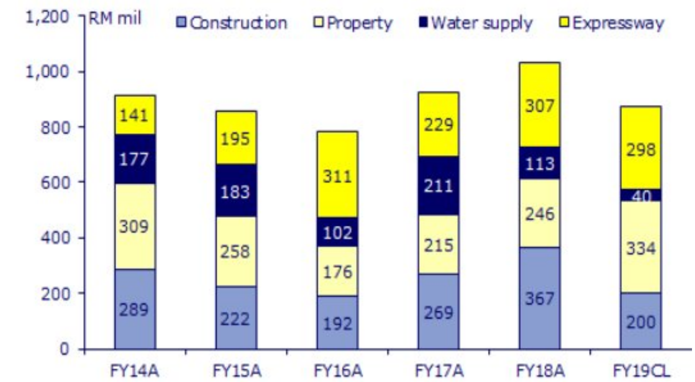
Gamuda: construction pre-tax profit and order book breakdown



Source: CLSA, Gamuda *reflects change in MRT2 to turnkey from project delivery partner model

Figure 17

Gamuda: pre-tax profit breakdown



Source: CLSA, Gamuda

Keen to participate but awaiting project structure and details first on the ECRL

For the ECRL, Gamuda had been involved previously with negotiations with China Communications Construction Company (CCCC) for one of the packages though without achieving success; pricing could have been one of the impediments. Thus, we see the possibility of Gamuda benefitting from the revival of the ECRL as a contractor so long as margins make sense. Gamuda has working relationship with CCCC, with the former as project delivery partner having a supervisory role over the latter in one of the systems parcel for MRT Line 1 (under a joint venture).

Ongoing spotlight on toll road negotiation

Gamuda's existing order book is still a significant RM11.8 bn (Oct 2018), consisting predominantly of the Klang Valley MRT Line 2, aside from Pan Borneo Highway (RM0.7 bn) and some other awards (RM0.9 bn). For the moment, attention will be devoted towards the toll road negotiations with the government, for which a timeline of about 6 months could be a reasonable estimate for the negotiations, according to finance minister Lim Guan Eng.

Target price unchanged

We improve the valuations of the construction division to an average 13x multiple, versus the 9x multiple that we had accorded as a trough cycle valuation post elections. Nevertheless, given that the negotiations on the tollroads may be seen to be an overhang, we widen discount to RNAV to 25% from 20%, pending clarity on the issue. All said, our target price of RM2.90 is unchanged.

Figure 18

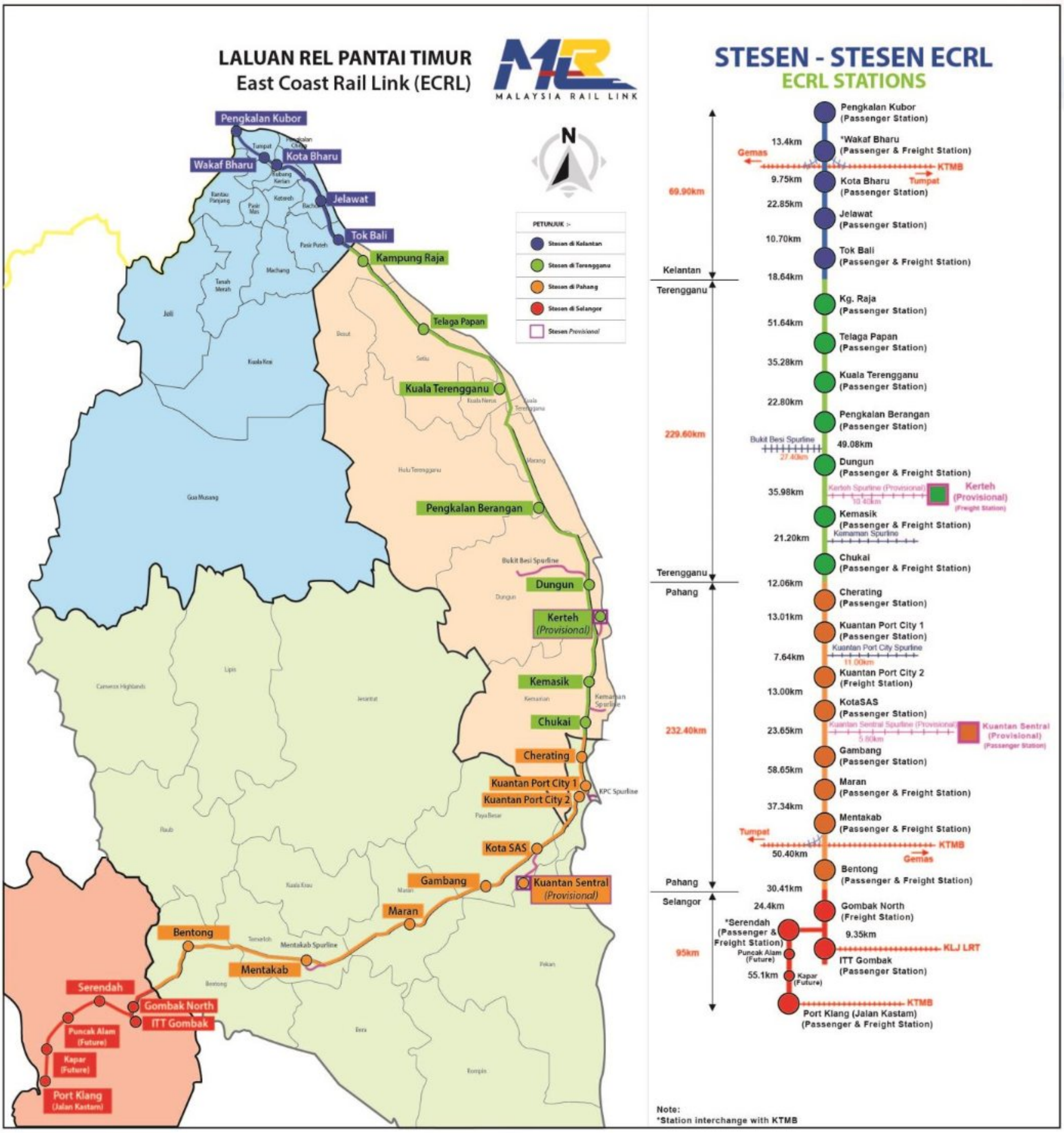
Gamuda valuation revisions

RM mn	Revised	Previous	
Malaysia	**RNAV (RM mn)**	**RNAV (RM mn)**	**Basis**
Construction	2,005	1,357	13x sustainable profit From previously 9x
Property division	3,557	3,557	12x sustainable profit (average Bursa Property Index)
Highway concessions	2,535	2,535	Discount of 30%
- of which LDP	1,249	1,249	
- of which SPRINT	762	762	
- of which Kesas	1,000	1,000	
- of which SMART	467	467	
SPLASH	1,020	1,020	
Water O&M contract	774	774	
OTHERS			
NPV of Vietnam projects, overseas concessions and net cash/(debt)	1,613	1,613	
SOTP	11,504	10,856	
Fully-diluted no. of shares (m)	2,994	2,994	
Fully-diluted RNAV/share (RM)	3.84	3.63	
Discount	25%	20%	Assumed 25% discount from 20%
Fully-diluted TP at discount to RNAV (RM)	2.90	2.90	
Source: CLSA			

Source: CLSA

Figure 19

ECRL map (as is, before any changes, if any)



Source: CLSA, Malaysia Rail Link

Figure 20

Construction peer comp

	Price	Mkt cap	ADT	PE		EPS Growth		PB		ROE		Yield		EV/ EBITDA	
	(RM)	(US$m)	(US$m)	CY18	CY19	CY18	CY19	CY18	CY19	CY18	CY19	CY18	CY19	CY18	CY19
				(x)	(x)	(%)	(%)	(x)	(x)	(%)	(%)	(%)	(%)	(x)	(x)
KLCI-listed peers															
IJM MK	2.1	1,875	1.53	19.2	15.9	(38.2)	15.8	0.8	0.8	4.5	5.1	2.3	2.6	9.9	9.0
GAM MK	2.9	1,756	4.39	12.9	12.6	(8.2)	3.0	1.3	1.3	7.7	7.6	4.2	4.4	11.0	10.5
SCGB MK Equity	1.8	579	0.39	17.29	17.9	10.10	(3.52)	4.25	3.98	25.98	22.92	3.85	3.85	9.89	9.03
EVSD MK Equity	0.5	99	0.80	6.5	6.2	9.7	5.1	0.5	0.4	6.8	7.1	2.3	1.0	8.3	9.1
HSL MK Equity	1.5	196	0.02	17.7	13.7	(31.7)	29.3	1.1	1.1	6.3	7.8	1.5	1.8	11.0	8.2
KICB MK Equity	1.2	100	0.02	6.1	7.4	(20.0)	(17.5)	0.7	0.6	11.2	8.5	4.2	3.9	5.9	6.4
MUHI MK Equity	3.0	350	0.45	11.2	9.3	20.0	20.1	1.3	1.2	12.1	13.5	2.0	2.5	8.0	8.2
GKEN MK Equity	1.1	148	1.92	8.6	5.4	61.7	59.2	1.7	1.4	25.5	17.0	4.6	7.9	2.8	3.2
TRC MK Equity	0.7	78	0.78	10.3	15.0	36.2	(31.3)	0.7	0.7	8.1	5.1	3.0	3.0	-	-
WCTHG MK Equity	0.8	279	0.46	8.0	10.8	17.2	(25.5)	0.4	0.4	4.9	3.9	4.0	3.2	18.3	17.0
GADG MK Equity	0.7	107	0.46	4.8	24.5	3.1	(51.1)	0.7	-	14.9	9.2	4.9	3.9	3.4	4.1
AQRS MK Equity	1.3	148	1.59	10.2	8.6	(46.9)	76.8	1.6	1.4	16.6	16.0	3.1	4.4	6.2	5.2
Weighted average				14.62	13.75	(12.30)	8.69	1.36	1.28	9.49	8.97	3.23	3.47	9.95	9.27
Weighted average ex. IJM & GAM				12.00	12.73	7.58	7.02	1.91	1.74	15.43	13.64	3.31	3.51	9.07	8.47

Source: CLSA, Bloomberg

Valuation details - IJM Corp Bhd IJM MK

Our valuation for IJM reflects PE-based valuations for its construction and industrial divisions and an RNAV-based valuation for its property segment with an 8.8% WACC and DCF for its concessionaire stakes, with a discount of 20%.

Investment risks - IJM Corp Bhd IJM MK

With near record high order book, the key risk is execution of the project to ensure profitability and completion according to schedule. Slower property demand due to weaker consumer sentiment has affected IJM's property sales and risk would be a sustained slowdown or further margin pressure. Rising labour costs could put pressure on construction profit margins. Regulatory risk related to toll-road and port concessions are not uncommon.

Valuation details - Sunway Construction Group Bhd SCGB MK

We value SunCon using the price-earnings multiple approach. Its target price is derived from 15.4x 20CL earnings which is at 1sd above 10-year mean PE for the KLCON index; we accord an above sector average PE given its flow of internal jobs and strong balance sheet.

Investment risks - Sunway Construction Group Bhd SCGB MK

The investment risks for SunCon mainly stem from construction risk. Specific risk to our estimates would be lower-than-expected margins (below 5-8%) or amount of projects secured falls below our expectation, either due to inability to secure projects or caused by delay on project roll-out. The increase in steel prices beyond anticipated will also creep into margins as SunCon hedges steel needs for a future six-month period. On the pre-cast segment, risks to our earnings will be timing of recovery of the margins currently in doldrums due to competition SunCon is also susceptible to risk facing the construction industry in general, which includes the risk of disputes and ensuing lengthy negotiations which is not uncommon, not to mention the fluctuations in raw materials and availability of labour.

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EVSD MK (N-R)
Fajarbaru (N-R)
Gadang (N-R)
GADG MK (N-R)
Gamuda (GAM MK - RM2.89 - SELL)
George Kent (N-R)
Hock Seng Lee (N-R)
HSS Engineers (N-R)
IJM (IJM MK - RM2.10 - BUY)
IJM Land (N-R)
IJM Plantations (N-R)
KICB MK (N-R)
Kimlun (N-R)
Lafarge Malaysia Bhd (N-R)
Mudajaya (N-R)
Muhibbah (N-R)
Scomi (N-R)
Splash (N-R)
SunCon (SCGB MK - RM1.82 - BUY)
Sunway (N-R)
TRC Synergy (N-R)
WCE (N-R)
WCT (N-R)
WZ Satu (N-R)

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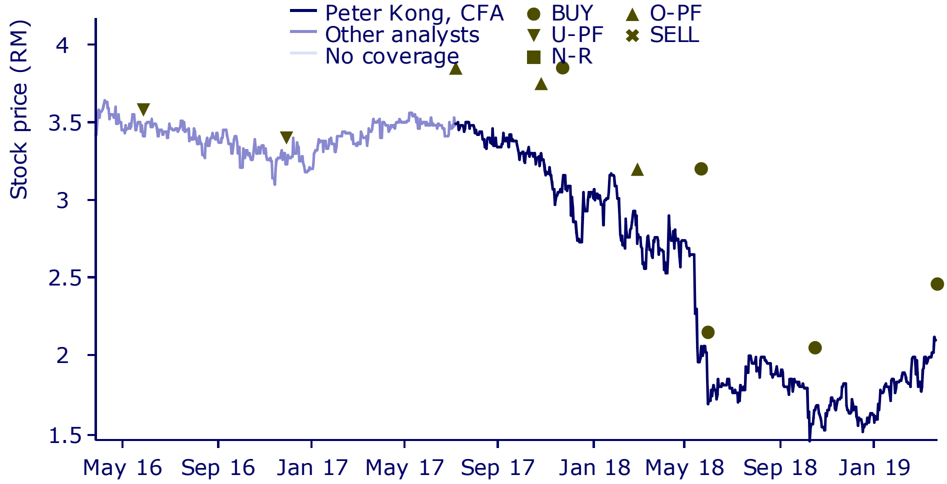
Important disclosures

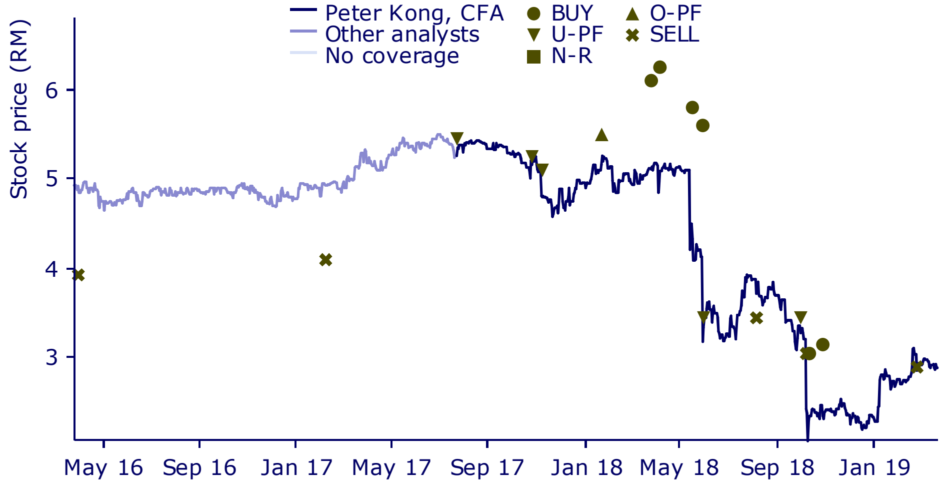
Recommendation history of IJM Corp Bhd IJM MK



Date	Rec	Target	Date	Rec	Target
LATEST	BUY	2.46	23 Nov 2017	BUY	3.85
17 Oct 2018	BUY	2.05	26 Oct 2017	O-PF	3.75
31 May 2018	BUY	2.15	07 Jul 2017	O-PF	3.85
22 May 2018	BUY	3.20	29 Nov 2016	U-PF	3.40
28 Feb 2018	O-PF	3.20	27 May 2016	U-PF	3.58

Source: CLSA

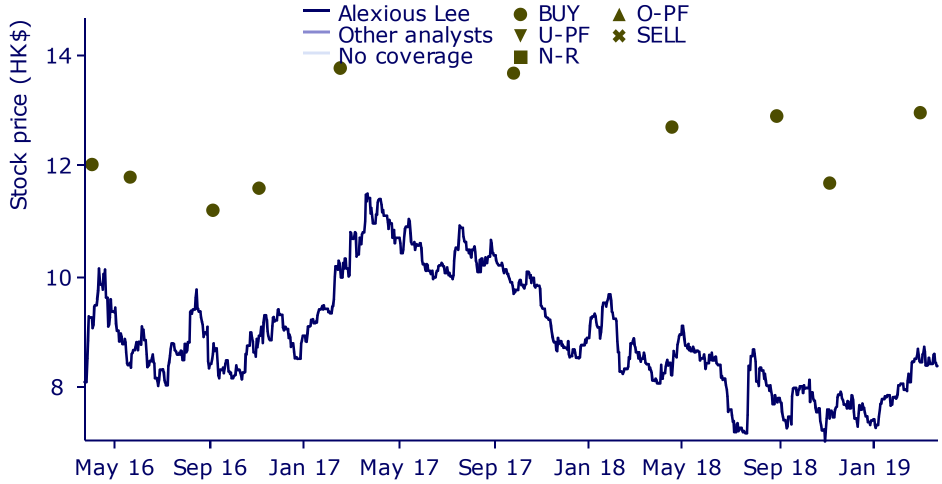
Recommendation history of Gamuda Bhd GAM MK



Date	Rec	Target	Date	Rec	Target
25 Feb 2019	SELL	2.90	06 Apr 2018	BUY	6.25
29 Oct 2018	BUY	3.15	26 Mar 2018	BUY	6.10
12 Oct 2018	BUY	3.05	22 Jan 2018	O-PF	5.50
08 Oct 2018	SELL	3.05	08 Nov 2017	U-PF	5.10
01 Oct 2018	U-PF	3.45	26 Oct 2017	U-PF	5.25
06 Aug 2018	SELL	3.45	23 Jul 2017	U-PF	5.45
31 May 2018	U-PF	3.45	07 Feb 2017	SELL	4.10
30 May 2018	BUY	5.60	31 Mar 2016	SELL	3.93
17 May 2018	BUY	5.80			

Source: CLSA

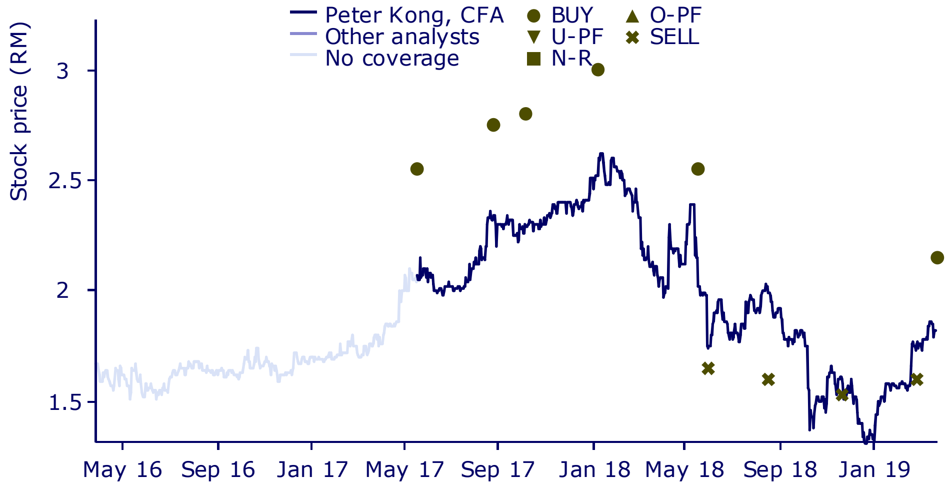
Recommendation history of China Communications Construction Co Ltd 1800 HK



Date	Rec	Target	Date	Rec	Target
01 Mar 2019	BUY	12.97	16 Feb 2017	BUY	13.78
05 Nov 2018	BUY	11.69	04 Nov 2016	BUY	11.60
29 Aug 2018	BUY	12.91	06 Sep 2016	BUY	11.20
17 Apr 2018	BUY	12.71	23 May 2016	BUY	11.80
26 Sep 2017	BUY	13.69	04 Apr 2016	BUY	12.03

Source: CLSA

Recommendation history of Sunway Construction Group Bhd SCGB MK



Date	Rec	Target	Date	Rec	Target
LATEST	BUY	2.15	18 May 2018	BUY	2.55
26 Feb 2019	SELL	1.60	08 Jan 2018	BUY	3.00
21 Nov 2018	SELL	1.53	06 Oct 2017	BUY	2.80
17 Aug 2018	SELL	1.60	25 Aug 2017	BUY	2.75
31 May 2018	SELL	1.65	18 May 2017	BUY	2.55

Source: CLSA

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