

Malaysia Industry Focus

Construction

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DBS Group Research . Equity

14 May 2018

Uncertainty discount

- Projects most at risk include ECRL and HSR; MRT 3 likely to go ahead but could be delayed
- Upside – higher local participation if Pakatan Harapan (PH) imposes limits on foreign contractors; revival of Penang Transport Master Plan (PTMP)
- Valuations to de-rate in short term; sector to benefit from better transparency in the longer term
- Downgrade Gamuda, WCT and Sunway Construction to HOLD

Back to the drawing board? We expect the construction sector to be de-rated following the election outcome as there will likely be delays, re-negotiation and/or cancellation for some key projects. One of Pakatan Harapan (PH)'s key manifestos is to review all mega projects awarded to foreign countries. In particular, the then opposition government (now new government) singled out two mega projects – East Coast Railway Link (ECRL) and KL-SG High Speed Rail (HSR) which may be impacted. Given the uncertainty in terms of time line, this may filter down to an eventual cut in earnings while sector valuation will also de-rate in light of the higher uncertainty.

What is more at risk? In our view, the ECRL project will face the strongest headwinds given there was more backlash on it from the onset in terms of its viability and contract value (cost per km). As the contract has already been awarded to China Communications Construction Company (CCCC), possible options include a re-negotiation or if an outright cancellation takes place, it will likely involve penalties. The latter is not likely in our view. An outright cancellation may erase RM16.5bn worth of subcontracting works (30% of RM55bn). For the HSR, it could still resurface later given the G-to-G relationship with Singapore and key agreements have been signed. Additionally, the most crucial Assetco award has yet to take place (extended till year-end) and will give the new government some time to deliberate further. The subcontracting packages for HSR from the two project delivery partners (PDPs) were also initially scheduled to be awarded at the earliest in early 2019.

New Government supportive of Belt and Road. Amidst all this uncertainty, we still expect our new government to be pragmatic and pro-development. Our New Prime Minister was recently quoted in saying the new government is supportive of the Belt and Road Initiative. He even wrote a personal letter to the China's President, Xi Jinping on the need for larger trains to connect Malaysia to Middle Asia and Europe while acknowledging China had the technology. The main issue of contention is the cost of some projects and the debt burden on the country's finances.

KLCI : 1,846.51

Analyst

Tjen San CHONG, CFA +60 3 26043972
tjensan@alliancedbs.com

STOCKS

	Price RM	Mkt Cap US\$m	12-mth		Rating
			Target Price RM	Performance (%) 3 mth 12 mth	
Gamuda	5.10	3,104	4.73	5.2 (4.3)	HOLD
IJM Corp	2.65	2,376	2.53	(2.2) (25.6)	HOLD
WCT Holdings Bhd	1.28	445	1.35	(14.7) (42.3)	HOLD
Sunway	2.39	763	2.18	(4.4) 14.9	HOLD
Muhibbah	3.04	361	3.42	0.0 2.7	BUY
Kimlun Corp	2.05	162	2.77	(4.7) (12.8)	BUY

Source: AllianceDBS, Bloomberg Finance L.P.

Closing price as of 08 May 2018

Selected Mega Projects

Projects	Est amount (RM bn)	Funding	Risk of cancellation
MRT Line 3	45.0	Foreign funding if CCCC wins. Local consortium has funding in place	Low
Gemas-JB double tracking	9.0	China Government	Medium
LRT 3	10.0	Malaysian Government	Low
Pan Borneo Highway	27.0	Malaysian Government	Low
East Coast Rail Link	55.0	Exim Bank of China	High
Penang Integrated Transport	27.0	Private sector (Land swap)	Low
High Speed Rail	60.0	Civil works funded locally. Assetco foreign funding.	Medium
JB-Singapore RTS Link	2.0	TBA	Medium

Source: Company, Various, DBSVickers, AllianceDBS,

What is more certain and is there upside? The MRT 3 project will likely go ahead as planned but the timeline will be fluid. Recall that Gamuda together with its JV partners MMC and George Kent are bidding for the main contractor role for MRT 3. Its other competitor is CCCC. The tender had already closed at end-January 2018 and the contract was supposed to be awarded by April 2018.

We expect the Penang Transport Master Plan (PTMP) project to kick off given one of the key hurdles was obtaining Federal Government approval for the LRT portion. Gamuda has a 60% stake in SRS Consortium, the PDP for this RM27bn project. The new government may also de-emphasise foreign participation particularly from the Chinese which would be positive for local established contractors.

Gamuda still the biggest beneficiary of MRT 3 but timing is key. The indicative contract value of MRT 3 is RM45bn if there are no changes. Assuming Gamuda's 45% stake in the consortium, this would imply a contract value of RM20.2bn. This would largely be high-margin tunnelling works given that 32km out of the 40km stretch are underground. Recall that the contract values for MRT Line 1 and Line 2 tunnelling works were RM8.2bn and RM15.47bn respectively or RM4.1bn and RM7.8bn for Gamuda's portion.

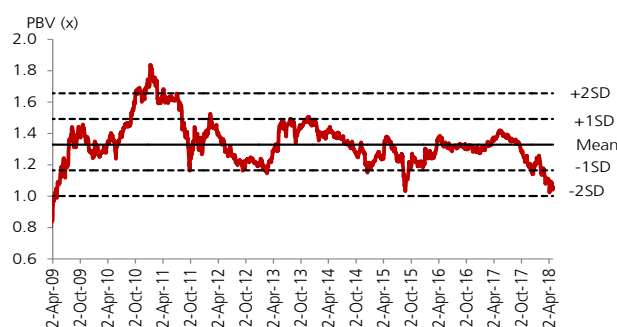
We think the MMC Gamuda-George Kent JV stands a good chance as MMC-Gamuda won the MRT lines 1 and 2 tunnelling works without having to exercise the Swiss Challenge or pricing advantage for local contractors. Nonetheless, the main issue here will be timing and if the new government will look to re-tender the project.

DBSV KL Construction – PE trading ranges



Source: DBSVickers, AllianceDBS, Bloomberg Finance L.P

DBSV KL Construction – P/BV trading ranges



Source: DBSVickers, AllianceDBS, Bloomberg Finance L.P.

Review of toll concessions. Apart from reviewing mega projects, one of PH's manifestos which may impact construction-related stocks is the plan to review all highway concession agreements with the aim of ceasing toll collection gradually. Eventually the plan is to acquire highways via the expropriation clause. This clause allows the government to do so if it is in 'national interest' which may be subjective. Stocks under our coverage which have toll concessions are Gamuda and IJM.

Valuations to de-rate in short term. On a market-weighted basis, our construction universe is now trading at mean levels on a PE basis and -2SD below mean on a P/BV basis. We expect this to de-rate further in the short term given the higher uncertainty now where contracts could be cancelled, deferred or even re-tendered. But in the medium-to-longer term, greater transparency, less bureaucracy and potentially less foreign competition could benefit established contractors (all in our universe). To be sure one of PH's key manifestos is to transfer Unit Kerjasama Awam Swasta (UKAS) from the Prime Minister's Office to the Ministry of Finance. We think the new government will still be pragmatic in terms of being pro-infrastructure development as evidenced in Penang and Selangor while the new Prime Minister during his tenure was also aggressive in rolling out important projects.

Changes in ratings and TP. Until there is further clarity on the validity of projects and timeline, we prefer to be more conservative and revise our ratings and TP as follows. We make no changes to our earnings forecast as yet.

Gamuda would appear to be most impacted among our universe as it relies the most on large-scale government projects. It is also the PDP for the Northern Section for HSR but we think this has yet to be reflected in its share price. On the flipside, it may benefit from a reduction in foreign participation in the Malaysian construction space given it is

still the go-to construction proxy while the long-awaited Penang Transport Master Plan may eventually take off. All in, we still downgrade our rating on the stock from BUY to HOLD with a lower SOP-derived TP of RM4.73.

The least impacted stock is **Muhibbah** as its construction business has not been actively participating in large-scale infrastructure projects and has a more diversified business model being also involved in marine-based and offshore projects. Additionally, 55-60% of its bottom line is driven by its cash-generating Cambodian Concession which is doing well. We are maintaining our BUY rating but with a lower TP of RM3.42.

We also downgrade our ratings on **WCT** and **Sunway Construction** from BUY to HOLD by assuming lower PEs to value their construction businesses. Our revised TPs are RM1.35 and RM2.18 respectively. But there is likely minimal downside to earnings as most of their targeted new wins are from internal projects and private sector building jobs.

For **IJM**, we are maintaining our HOLD rating but lower our SOP-derived TP to RM2.53. In the event, the ECRL is cancelled this would be negative for IJM as its Kuantan Port Concession and stake in Malaysia Chinese Kuantan Industrial Park were touted as key beneficiaries of this project.

For **Kimlun**, we are maintaining our BUY rating but with a lower TP of RM2.77. While there will be some impact on its manufacturing business if MRT 3 and HSR is delayed, we believe its bread and butter business of constructing affordable housing and presence in Singapore's MRT and Deep Tunnel Sewerage system projects may compensate for this.

Please see the table below for details on our revised ratings, TPs and assumptions.

Key Changes in Stock Recommendation and Target Prices

Company	Current Rating	New Rating	Current SOP-derived TP (RM/share)	New SOP-derived TP (RM/share)	Change in assumptions
Gamuda	Buy	Hold	6.70	4.73	No new orders, 30% discount for Splash, 30% discount for toll roads
IJM	Hold	Hold	3.00	2.53	Lower PE of 13x for construction (vs 16x), 30% discount for toll concessions
WCT	Buy	Hold	1.76	1.35	Lower PE of 11x for construction (vs 14x)
Sunway Construction	Buy	Hold	2.60	2.18	Lower PE of 12x for construction (vs 14) and lower PE of 14x for manufacturing (vs 16x)
Muhibbah	Buy	Buy	3.60	3.42	Lower PE of 11x for construction (vs 13x)
Kimlun	Buy	Buy	3.06	2.77	Lower PE of 9x for construction (vs 10x) and lower PE of 11x for precast (vs 12x)

Source: DBSVickers, AllianceDBS, Bloomberg Finance L.P.

Status of Selected on-going mega projects

Projects	Est amount (RM bn)	Est commencement date (before new government)	Est completion date (before new government)	Status updates	Funding	Risk of cancellation
MRT Line 3	45.0	2H2018	2025/26	MRT 3 to be awarded via turnkey basis. Two consortiums short listed - Gamuda-MMC-George Kent and CCCC	Foreign funding if CCCC wins. Local consortium has funding in place	Low
Gemas-JB double tracking	9.0	2018	End-2020	Project already awarded to 3 China parties where they will subcontract works out to local players. YTL supposed to be lead contractor for local portion.	China Government	Medium
LRT 3	10.0	2H-2017	2020	Majority of the project has been awarded. Works have started.	Malaysian Government	Low
Pan Borneo Highway	27.0	End-2017	2022	The Sarawak portion has been largely awarded. A few packages for the Sabah portion have been awarded. Total contract value for Sabah is RM12.8bn	Malaysian Government	Low
East Coast Rail Link	55.0	2018	2024	Awarded to CCCC. Works have started. Expect local players to reap as much as 30% of total project value	Exim Bank of China	High
Penang Integrated Transport	27.0	TBA	TBA	Project likely to take off now. SRS Consortium appointed PDP	Private sector (Land swap)	Low
High Speed Rail	60.0	2018	End-2026	Two PDPs appointed for Northern and Southern Section. Assetco tender extended till year end.	Civil works funded locally. Assetco foreign funding.	Medium
JB-Singapore RTS Link	2.0	TBA	TBA	TBA	TBA	Medium

Source: Company, Various, DBSVickers, AllianceDBS

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STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return i.e. > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame)

Share price appreciation + dividends

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HONG KONG**DBS Vickers (Hong Kong) Ltd**

Contact: Paul Yong
18th Floor Man Yee Building
68 Des Voeux Road Central
Central, Hong Kong
Tel: 65 6878 8888
Fax: 65 65353 418
e-mail: equityresearch@dbs.com
Participant of the Stock Exchange of Hong Kong

MALAYSIA**AllianceDBS Research Sdn Bhd**

Contact: Wong Ming Tek (128540 U)
19th Floor, Menara Multi-Purpose,
Capital Square,
8 Jalan Munshi Abdullah 50100
Kuala Lumpur, Malaysia.
Tel.: 603 2604 3333
Fax: 603 2604 3921
e-mail: general@alliancedbs.com

SINGAPORE**DBS Bank Ltd**

Contact: Janice Chua
12 Marina Boulevard,
Marina Bay Financial Centre Tower 3
Singapore 018982
Tel: 65 6878 8888
Fax: 65 65353 418
e-mail: equityresearch@dbs.com
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INDONESIA**PT DBS Vickers Sekuritas (Indonesia)**

Contact: Maynard Priajaya Arif
DBS Bank Tower
Ciputra World 1, 32/F
Jl. Prof. Dr. Satrio Kav. 3-5
Jakarta 12940, Indonesia
Tel: 62 21 3003 4900
Fax: 6221 3003 4943
e-mail: research@id.dbsvickers.com

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Contact: Chanpen Sirithanarattanakul
989 Siam Piwat Tower Building,
9th, 14th-15th Floor
Rama 1 Road, Pathumwan,
Bangkok Thailand 10330
Tel. 66 2 857 7831
Fax: 66 2 658 1269
e-mail: research@th.dbs.com
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