21 March 2017 | Sector Update

Construction

***Maintain* POSITIVE**

Liquidity Fillips KLCon Index Valuation

SECTOR HIGHLIGHTS

- **Construction sector entering an upcycle**
- **Total conventional projects aggressive CAGR rate**
- **Stable loan disbursed lends support to the sector**
- **Attractive but expensive valuation**
- **But law of gravity applies as value is the best arbiter**
- **Due to sectoral cycle; value prevails**
- **Maintain Positive on sector**

Construction sector entering an upcycle. The KL Construction Index has climbed to a new high of 25.43x - its highest since its lowest PER of 5.8x in 2011 alongside with recent lifting of share performance for index heavyweights such as IJM (TP: RM4.00, YTD:7.8%) and Gamuda (TP: RM5.50, YTD: 8.3%). The uptick illustrates a conformance to higher macroeconomic activity in the construction sectors such as higher total conventional project awards (*Figure 1*) coupled with the total loans disbursed by financial institutions (*Figure 2*).

Total conventional projects aggressive CAGR rate. Notably,for the period of 1QFY16 to 4QFY16, the total conventional projects awarded rose aggressively with CAGR of +68.3% driven by segments of residential, infrastructure and new projects awarded. Currently, we are experiencing its positive impact derived from the surge in construction loans disbursed. For example, in Jan-17 RM7.4bn loans disbursed was the highest since Jan-14 (RM7.4bn) combined with the aggressive rate of total conventional projects awarded hence the uptrend in KLCon Index.

Stable loan disbursed lends support to the sector. The construction sector is receives constant loan disbursement rate for FY16 amounting to RM67.42bn (+3.5%yoy) combined with 11,875 (+2.5%) projects as opposed to Dec-15 amounting to RM65.13bn on the back of 11,583 projects. We observe that liquidity underpins the surge for; (i) residential, non-residential (buildings), infrastructure conventional construction segments and (ii) healthy construction trend in states such as Penang, Sabah, Sarawak, Selangor and Federal Territory. (Figure 3A-3F)

Attractive but expensive. As a result, the valuation of KLCON Index i.e. price-to-earnings (p/e) and price-to-book (p/b) ratios travelled further than expected. We notice that sectoral earnings is set to increase due to; liquidity flux to the construction sector which constantly remains between RM4.01bn to RM7.0bn.

Liquidity fillips valuation. Consequently, enlarges the balance sheet of construction companies via lifting of non-current and current assets for example; receivables and short-term fundings. Secondly, liquidity fillips the current p/e ratio median of the KLCon Index to 25.56x from its preceeding period (March-16) of 16.2x. Against the milieu of credit liquidity, we reckon that the median p/e ratio could go as high as 35.4x. The prospect of 35.4x p/e levels look undemanding if we compare to the rate of loans disbursed. (Figure 4 and 5)

But law of gravity applies as value is the best arbiter. The choice is no binary outcome - if we think about growth then sector still have room to grow due to fillip of loans that could potentially stimulate the Index's p/e ratio to 35.4x. Based on the liquidity in the sector, even current p/b ratio of 1.3x looks arguably low compared to the liquidity which could encourage it to 1.8x p/b level. However, laws of gravity apply; between the period of May-2010 to September-2010, KL Construction Index p/b ratio went to 1.8x but went below 1.0x p/b in May-2011. Currently, KLCon Index p/b went is trading below 1.0x p/b which looks undoubtedly appealing. But to separate the wheat from the chaff, convergence of sectoral p/b and p/e ratios unmasks the dizzying height.

Due to sectoral cycle; value prevails. The KLCon Index p/e and p/b ratios currently trades at almost parity which coincides with the sector's highest p/b level on May-2010. Consequently, the sectoral p/e ratio fell in Jan-2011 to reach its lowest ebb in Jan-2012 in which continue to trade between the ranges of 5x-20x p/e ratio for the next 5 years (Dec-16) We believe that the valuation cycles of 2010-2011,is set to repeat. Due to the fillip of credit, earnings will expectedly expand and p/e ratio will ascend for the period of 2QFYE17 to 4QFYE17. Beyond that, it will probably normalize to reflect p/e ratio level which corresponds to p/b ratio lower than 1.0x. (Figure 6). We deemed the Index's movement as a consequent of liquidity impulse.

Maintain Positive. Nonetheless, we maintain our positive stance on the construction sector with **Muhibbah (TP RM3.05)** and **MRCB (TP RM2.08)** as our top picks. We reckon that the current higher risk-taking mode sweeping the market should be tracked closely and recommends taking long/short position of construction companies regardless of market capitalization based on the balance of parity between p/b and p/e ratio for KL Construction Index.

***Exception.** We exclude figures for July-2008 as it skews our observation as the figures for p/e and p/b ratio reflects the significant drop in sectoral earnings causing p/e and p/b ratios to reach 1619.2x and 164.4x respectively.

DAILY PRICE CHART

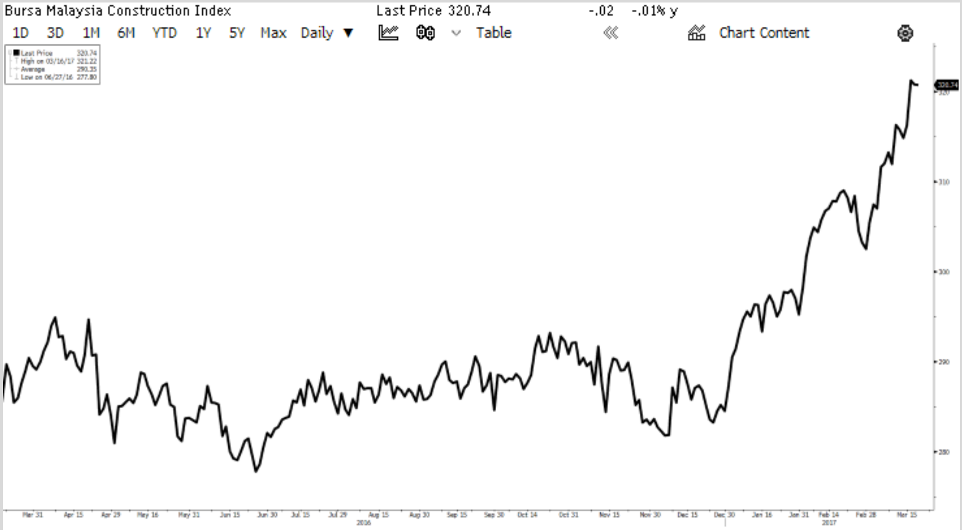

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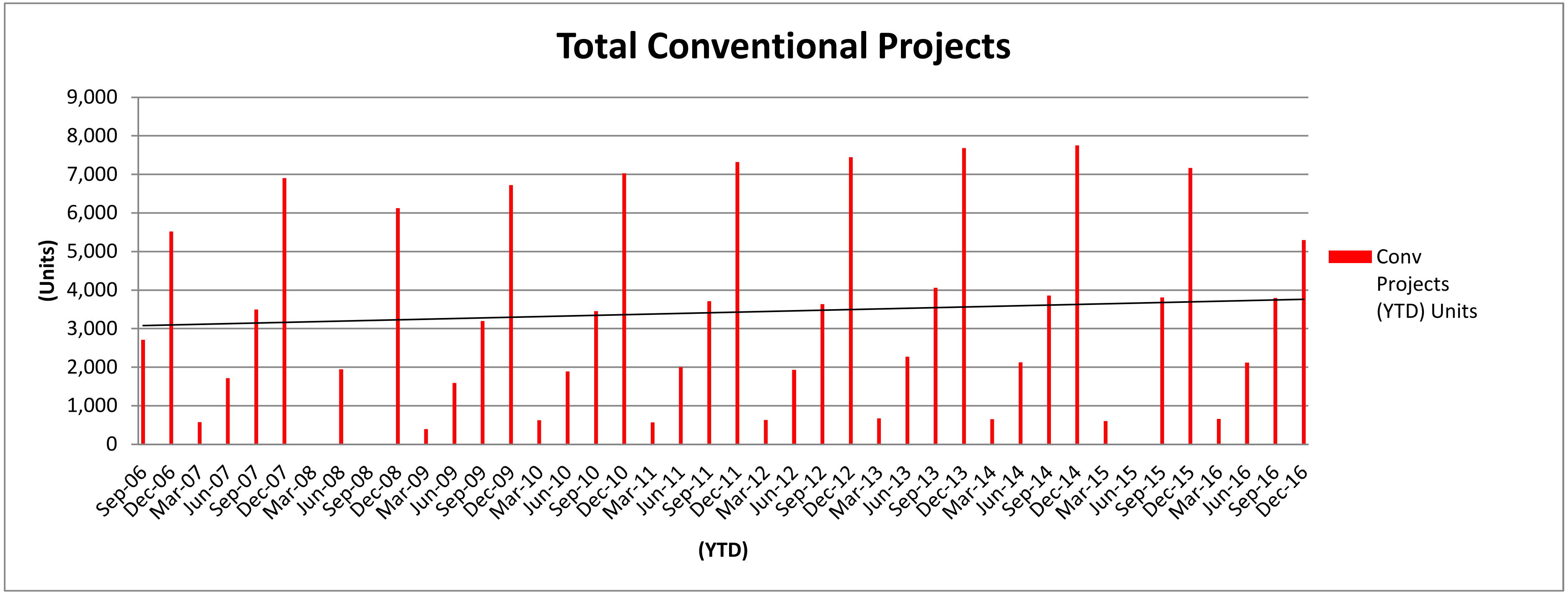
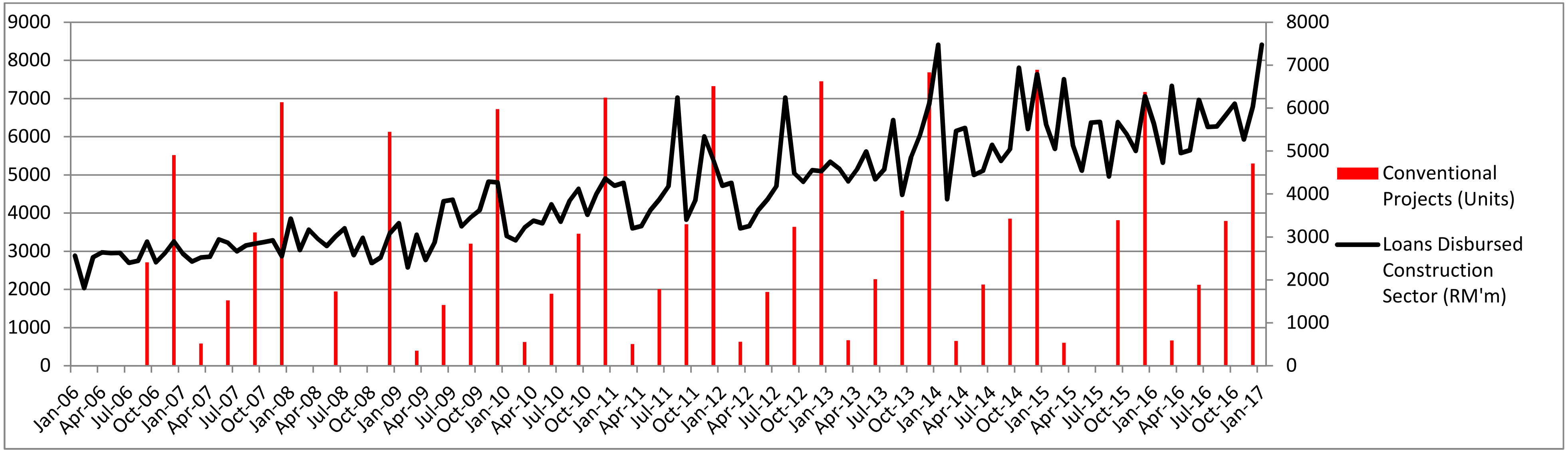
FIGURE 1: CONVENTIONAL PROJECTS



Source: CEIC, DOS, CIBD

FIGURE 2: CONVENTIONAL PROJECTS VS. LOANS DISBURSED



Source: CEIC, DOS, CIBD

FIGURE 3A: FEDERAL TERRITORY

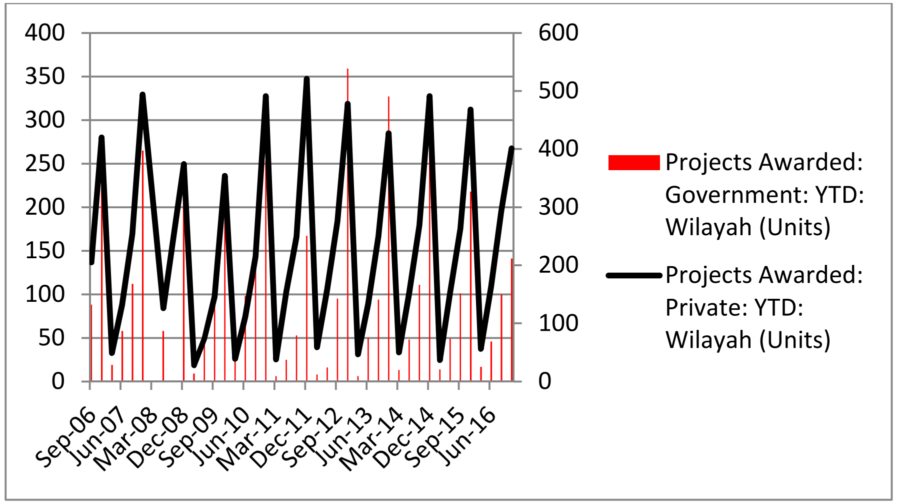


FIGURE 3B: SARAWAK

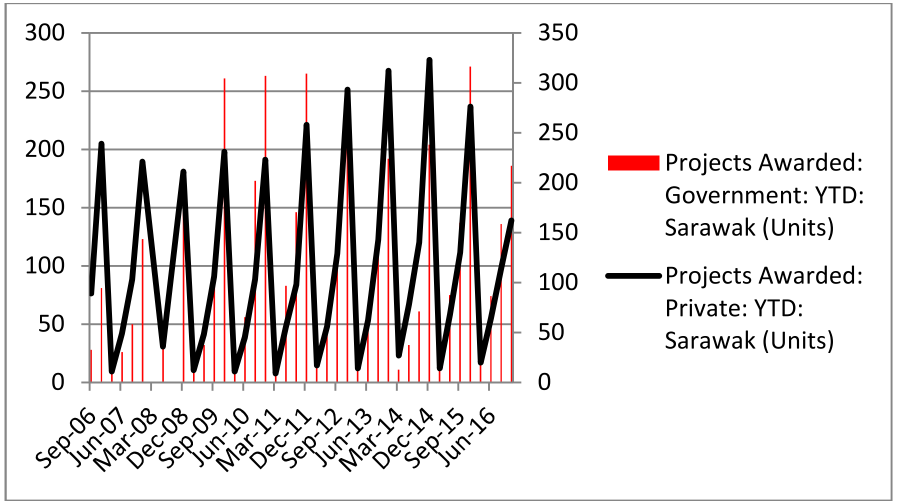


FIGURE 3C: SABAH

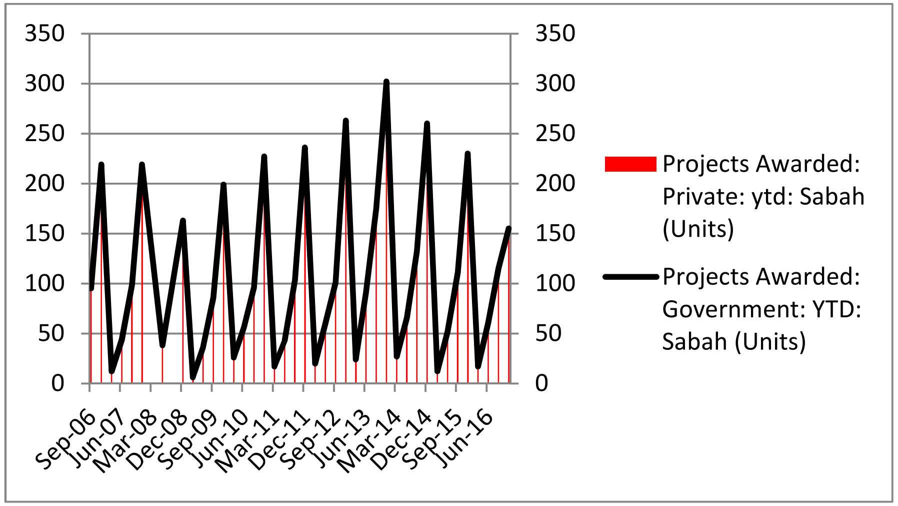
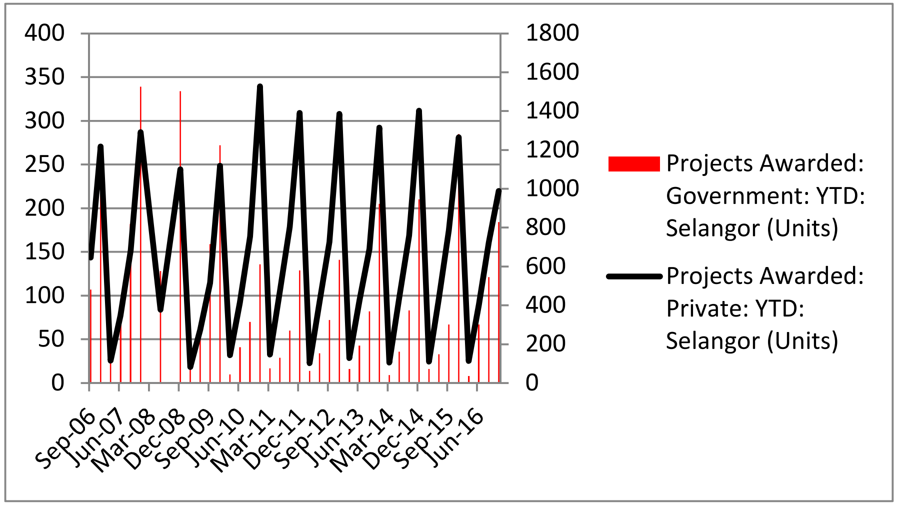


FIGURE 3D: SELANGOR



Source: CEIC, DOS, CIBD

FIGURE 3E: PENANG

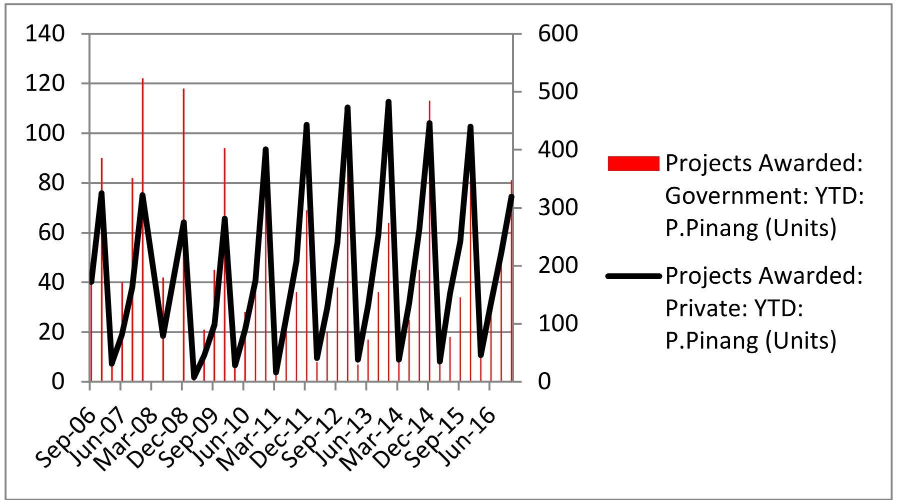
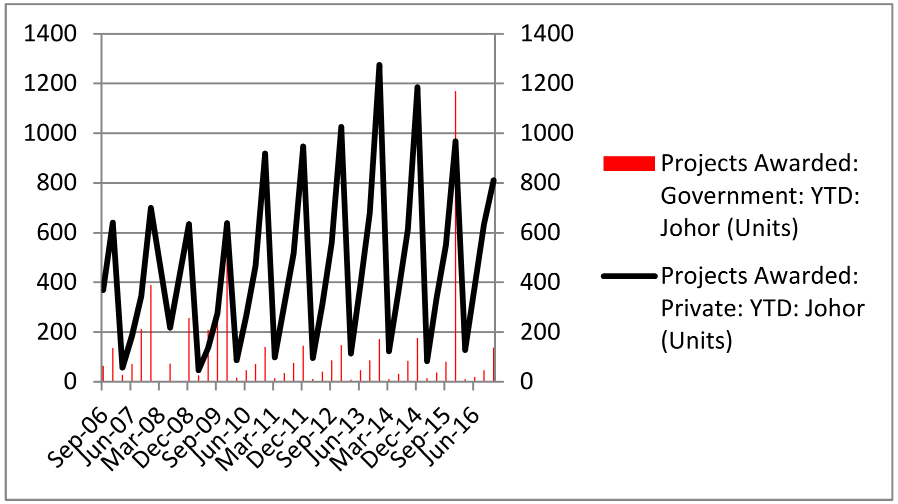
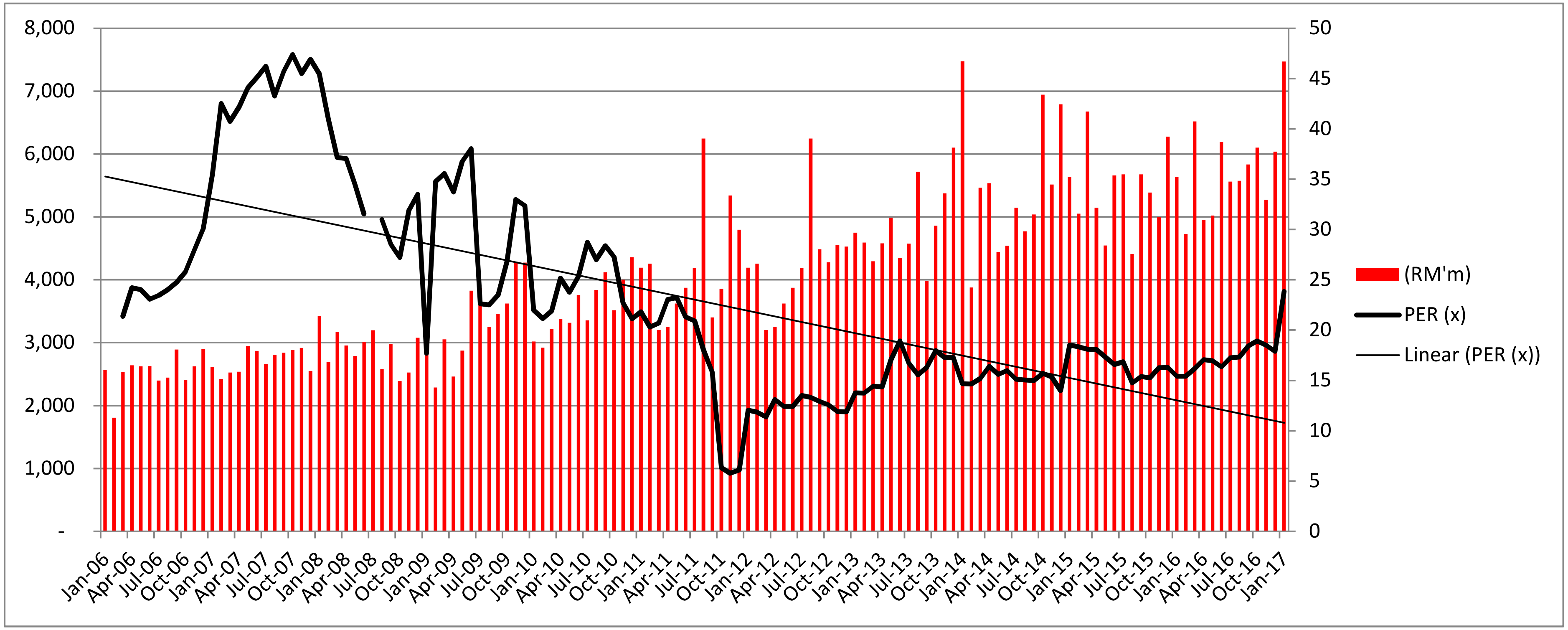


FIGURE 3F: JOHOR



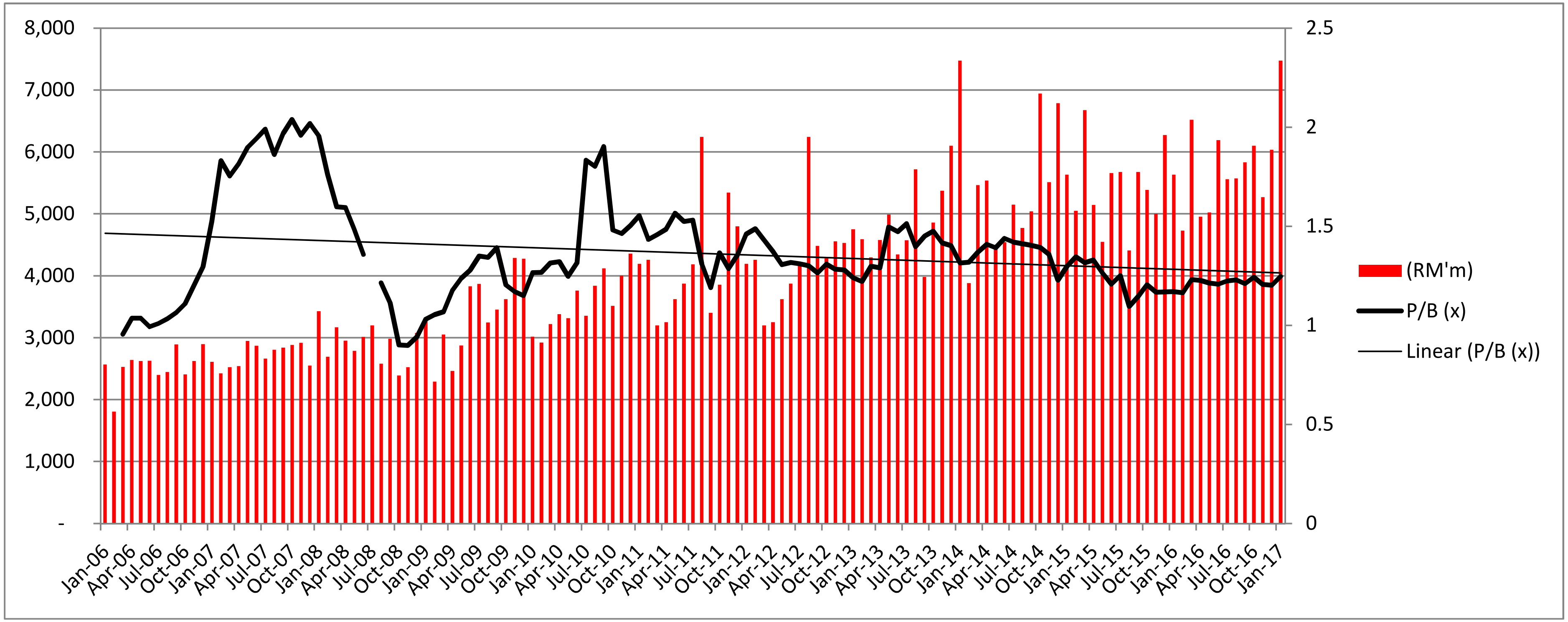
Source: CIDB, & DOS

FIGURE 4: KLCON PRICE-TO-EARNINGS RATIO VS. LOANS DISBURSED



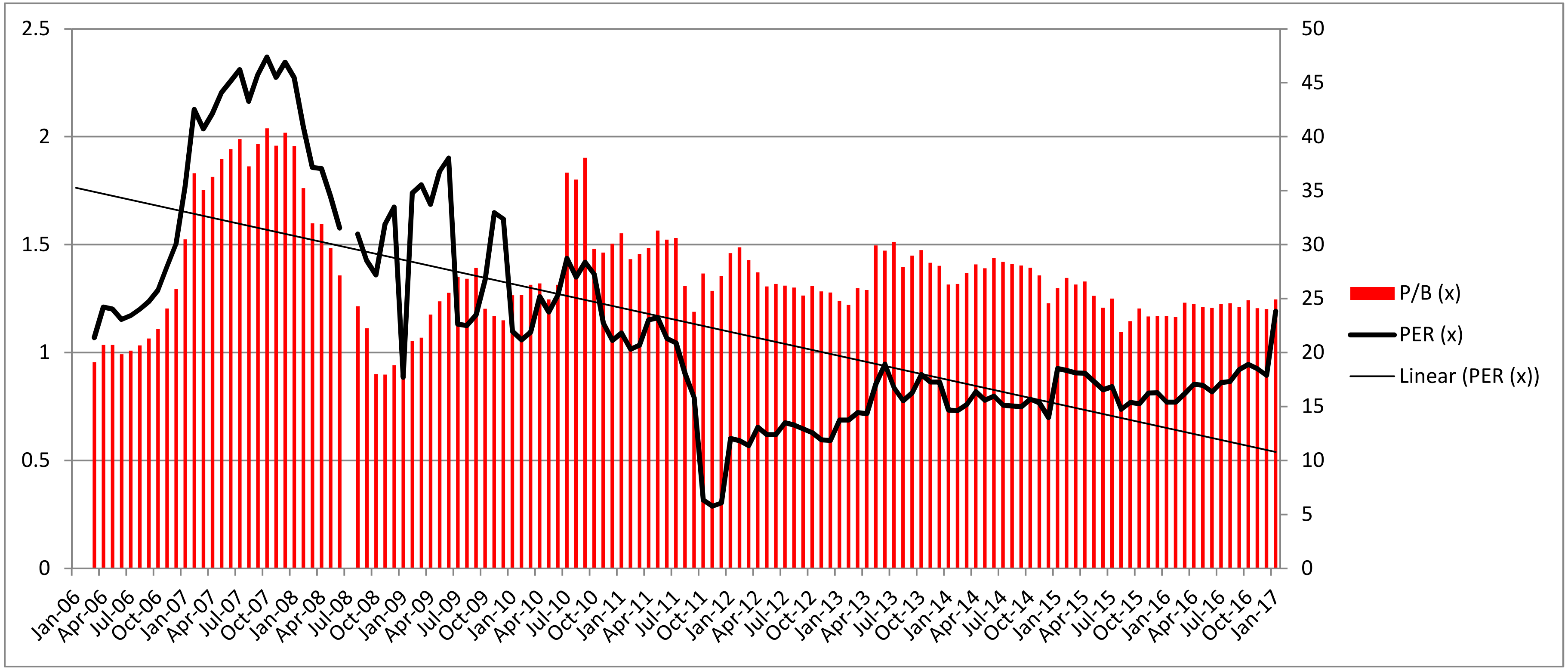
Source: CIDB, Bloomberg & DOS

FIGURE 5: KLCON PRICE-TO-BOOK RATIO VS. LOANS DISBURSED



Source: CIDB, Bloomberg & DOS

FIGURE 6: KLCON'S PRICE-TO-EARNINGS & PRICE-TO-BOOK CONVERGENCE



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STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.