**25 September 2017 | Sector Update (Part 1)**

# Construction

***Maintain* POSITIVE**

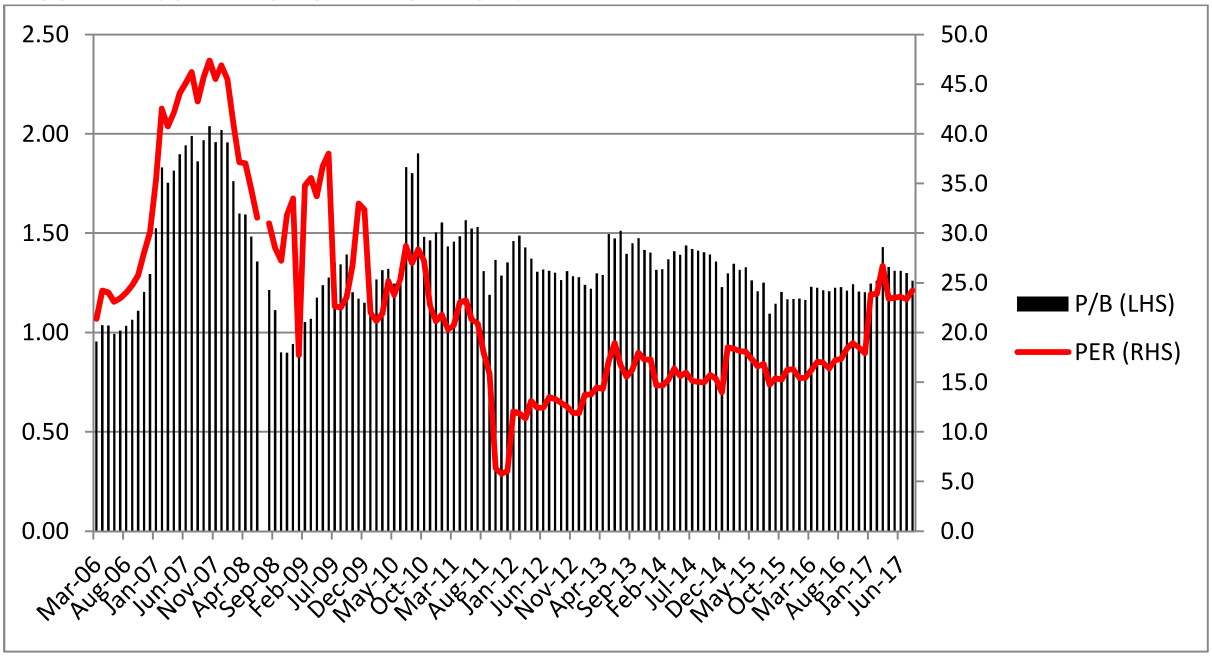
## *Plagued by Temporary Setback and Ominous Signs*

### INVESTMENT HIGHLIGHTS

- **Valuation shifts to higher gear but ominous signs sprouting**
- **Plagued by uneven earnings**
- **Embracing the new anchor**
- **Maintain Positive**

**Valuation shifts to higher gear but ominous signs sprouting.** Valuation of KL Construction Index is set to climb higher as the price-to-earnings (PER) and price-to-book (PBR) starts to converge again to reflect (*Figure 1*) the intensifying news flow on the sector. Sectoral PER climbed to 22.9x which is closer to its 11-year average of 24.2x. From PBR standpoint, the sector fetches only 1.26x PBR below its mean of 1.36x. Despite that, 'writings on the wall' such as (i) drop in infrastructure projects and (ii) uneven earnings for big caps and small-mid caps construction companies are ominous for the sector.

**FIGURE 1: CONVERGE OF VALUATIONS**



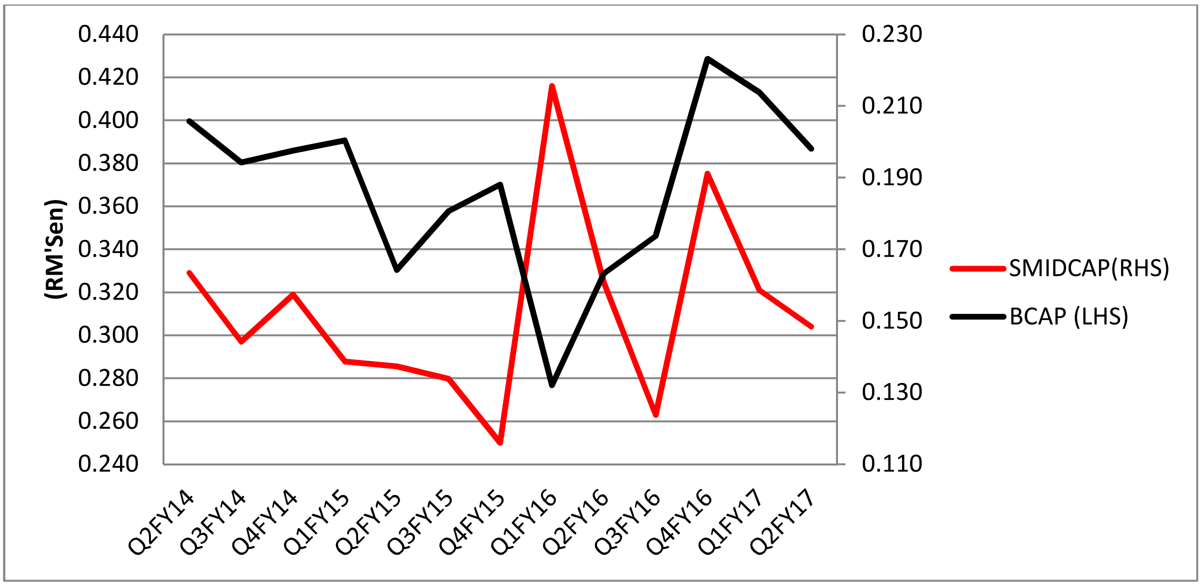

*Bloomberg, MIDFR **

**Plagued by uneven earnings.** Compression and uneven earnings in big-caps is seen through the accretion of infrastructure projects to the construction company's bottom line. For example, Pan Borneo Highway (Sarawak) was awarded to several companies such as WCT Holdings Berhad and Cahya Mata Sarawak in July, 2016. Despite that, the progress is still at an early stage hence meaningful impact to WCT and Cahya Mata 1HFY17 earnings is still undemonstrative. (*Figure 2*) We reckon that the trend will persist due to joint-venture (JV) and project delivery partner (PDP) structure of the mega-projects is regressive to earnings upside. For instance, the revenue per share (RPS) of big caps construction companies (BC3*) has lagged the RPS of small-mid caps construction companies (SMC3*). Eventhough, BC3 CAGR grows +18.6% QoQ but SMC3 registered a better growth of +30.9%QoQ. However, revenue growth does not always translate into healthy earnings. Earnings per share (EPS) for BC3 (CAGR: +4.6%QoQ) and SMC3 (CAGR: +2.9%QoQ) under our observation have decreased due to; (i) higher expenses, (ii) longer project period and (ii) gaps in billings recognition. We opine that longer termed contract yields lower margin compared to packages with shorter duration hence the dovish EPS growth for SMC3. *(Figures 3 and 4)*

**FIGURE 2: 1HFY17 RESULTS UNDEMONSTRATIVE**

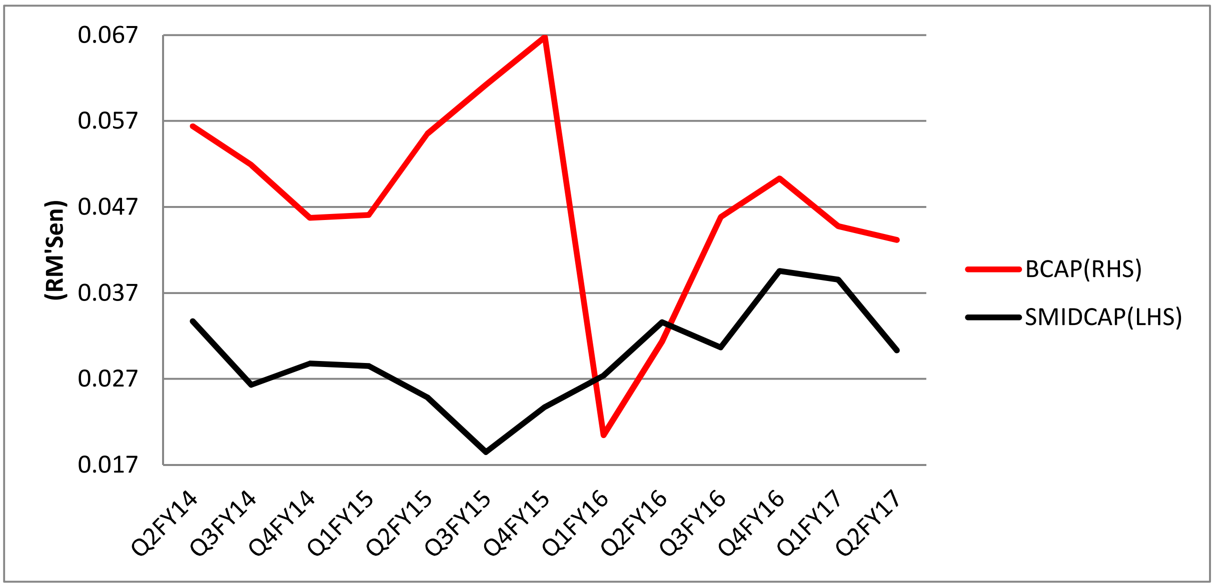
| Companies | 1HFY17/18 Results Expectation | Comments |
|---|---|---|
| IJM Berhad | Below | Higher finance cost |
| CMS | Below | Lower revenue from key divisions |
| WCT | Below | High liabilities |
| VIVO | Below | Billings gap |
| Gabungan AQRS | Below | Revised expectations |
| HSL | Below | Billing gap |
| Sunway Construction | Below | Lower contribution from pre-cast segment |
| Muhibbah | Met | Consistent PBT from airport concession |

**FIGURE 3: REVENUE PER SHARE**




*Bloomberg, MIDFR*

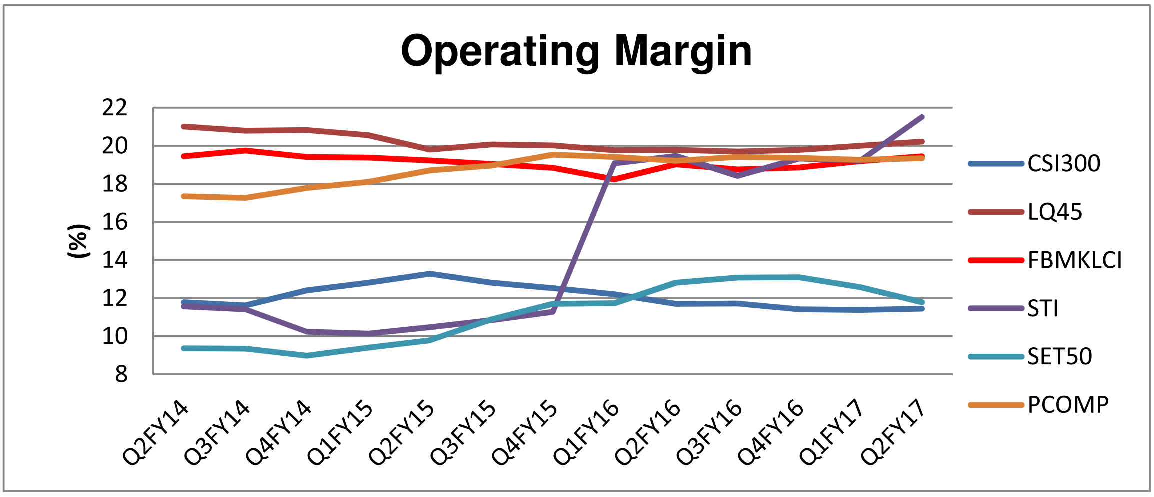
**FIGURE 4: EARNINGS PER SHARE**




*Bloomberg, MIDFR*

**Embracing the new anchor.** Furthermore, the policy of the Malaysian government opening its wide arm to the One Belt One Road Policy enables China state-owned enterprises (SOEs) to participate freely in construction projects to improve its risk-reward profile. Large China's construction SOE such as the China Railways Engineering Corp. and China Railways Construction Corp has made strong developments in Malaysian construction sector – shrinking the impact to local companies further. The 'Buffett Indicator' or total market cap to GNI (gross national income) of China is 92.5% and its 3-y forward earnings are -0.86%. With an anaemic earnings climate in China is only natural for its SOEs to look for better opportunities. We believe the push factor for China's SOE to Malaysia is the insipid 3- year operating margin of CSI300 (Mean:+12.1%) compared to rest of FBMKLCI and ASEAN. Generally, Malaysia's stable operating margin proxied by FBMKLCI's average of +19.12% is a boon for China's SOE. (*Figure 5*). We maintain our positive stance despite blips in our expectation as we believe FYE18 beckons better results due to higher revenue recognition coupled with catalysts of subcontracting packages from China's SOE.

**FIGURE 5: FBMKLCI OPERATING MARGIN VS. ASEAN &CSI300**




*Bloomberg, MIDFR*

***BC3:** Sample of Big Caps Construction Sector is represented by Cahya Mata Sarawak, IJM Bhd. Gamuda Bhd. and WCT Holdings Bhd. We exclude Sunway Construction due to the comparability of timeline and its recent status in KL Construction Index and MRCB due to its exposure in property development.*

**SMC3:** Sample of small-caps construction companies are represented by Gadang, Vivocom, Gabungan AQRS, Ekovest, Econpile, Kerjaya Prospek, Fajar Baru Builder, Hock Seng Lee, Pintaras Jaya and Muhibbah due to its orderbbok and revenue growth.*

## DAILY PRICE CHART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## DISCLOSURES AND DISCLAIMER



| MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS | |
|---|---|
| **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. |