midf RESEARCH

2 April 2017 | Sector Update

Construction

***Maintain* POSITIVE**

Unmasking Real Attraction

SECTOR HIGHLIGHTS

- **Stable loans disbursement rate**
- **Unwavering construction sector's PER**
- **PB/R rationalizes lofty PER level**
- **Earnings yield unmasks sector's real attractiveness**
- **Maintain Positive**

Stable loans disbursement rate. The construction sector receives constant loan disbursement rate continuously for Feb-17 amounting to RM5.19bn (+9.9%yoy,-30.4%mom). From Jan-06 to Feb-17 the average monthly credit liquidity to the construction sector amounts to RM4.11bn. We expect that the consequent monthly credit liquidity to the construction sector would remain between the ranges of RM4.5bn to RM5.1bn until Oct-17. In our view, the sharp increase of constructions loans disbursed in January amounting to RM7.3bn will not be repeated to prevent excess liquidity. Considering, the influx of news for the sector i.e. LRT3 announcements and possible ports construction in Kuala Linggi, Melaka and Pulau Carey, Klang, the sector's expansion will be stunted should the liquidity dries to the sector as seen in 2010 and 2012 where average loans disbursed chalked only RM4.3bn and RM4.5bn respectively. *(Figure 1: Projects vs. Constructions Loans Disbursed).*

Unwavering construction sector's PER. However, valuation expectedly gathered steam with an unwavering construction sector PER of 23.9x as at end Feb-17 compared to 15.4x in Feb-16 (+8.5ppts). We believe that the Street has taken notice of the dizzying valuation and therefore stagnated the advancement of the sectoral PER by taking profit. Minimal month-on-month changes from Jan-17 of 23.8x to Feb-17 23.9x (+0.01ppts) of the sectoral PER beckons the start of valuation normalizing below its median of 22.8x PER. We are guided partially by the sectoral PER to determine the appropriate valuation basis in our sum-of parts (SOP) valuation for our coverage. For example, we could not rationalize assigning a higher multiple i.e. sector median of 22.8x PER to justify lofty valuations for **SCGB (TP: RM1.74)** as this means a steep increase in its book value from RM2.3bn to RM4.35bn (+86.9%) without any increase in; i) revenue, (ii) earnings, (iii) operating cash flow and (iv) orderbook expansion of minimum +10.5%. Given the estimated book value of RM4.3bn (divided by 1.29m shares) our target price of SCGB will swell to RM3.32. Although, credit liquidity still fillips the valuation for Kuala Lumpur Construction Index in Feb-17, we remain steadfast that it is due partly to; (i) liquidity impulse and (ii) anticipation of election. As pointed in SCGB's scenario, higher valuation could backfire once the liquidity impulse dried or Street is swept again by any risk adverse sentiment such as widening USD/MYR, oil price decline and political instability. *(Figure 2: PER vs. Constructions Loan Disbursed)*

PB/R rationalizes lofty PER level. On the other part, we distil our perspective further by taking P/BR into account. The sector P/BR seems to rationalize best on the state of valuation for construction sector. As reasoned, if we assign lofty PER median of 22.8x across our coverage, the 'irrational exuberance' would be uncovered by the sector's P/BR sooner or later. *(Figure 3: PBR vs. Construction Loans Disbursed)*. At writing, the sector's PER and P/BR has almost reach parity (*Figure: 4 PBR vs PER*). Given the current PER level, the sector's P/BR is equated at 1.25x. As a result, we advise taking due caution as this could mean the sector is has reach full valuation. *Tweedy Browne (2014)* has summed the impact of investing in low P/BR value companies as compared to high P/BR value companies study by NBER* in 1993. The study suggests that low P/BR stocks outperformed the high P/BR stocks in 16 of the 22 years of observation or 73% of the time.

Earnings yield unmasks real attractiveness. However to balance our views, we rely upon the findings of Basu (*1982*) which found that returns on equity appear to have been related to earnings' yield and firm size. In particular, the "common stock of high E/P firms seem to have earned, on average, higher risk-adjusted returns than the common stock of low E/P firms". Thus it is pertinent to highlight that despite the P/BR and PER of our coverage, earnings yield plays an important part. As illustrated, we found companies that are attractive through the P/BR and PER perspective may not necessarily make the mark. We opined that at current market level, most of the household construction companies do not have attractive earnings yield hence the market is reaching its parity in valuation. (*Figure 5: Earnings Yield*)

Maintain Positive. Altogether, we maintain our positive stance on the construction sector with a stronger whiff of caution; we will only reassess our view on construction sector if all our top picks hit the target price and the spread between the sector's earnings turns negative against the yield of 5-Y Malaysian Government Securities. (Currently, the spread between the sector's earnings yield and 5-Y MGS is +0.24%.) So far, we still favour **MRCB (TP RM2.10),** but we exclude **Muhibbah (TP RM3.05)** due to reaching its target price. 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 as well as earnings yield – to uncover whether it is really attractive or only appears to be attractive.

***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.*

P/BR :** *Price to Book Ratio* * ***PER *: Price to Earnings*

DAILY PRICE CHART

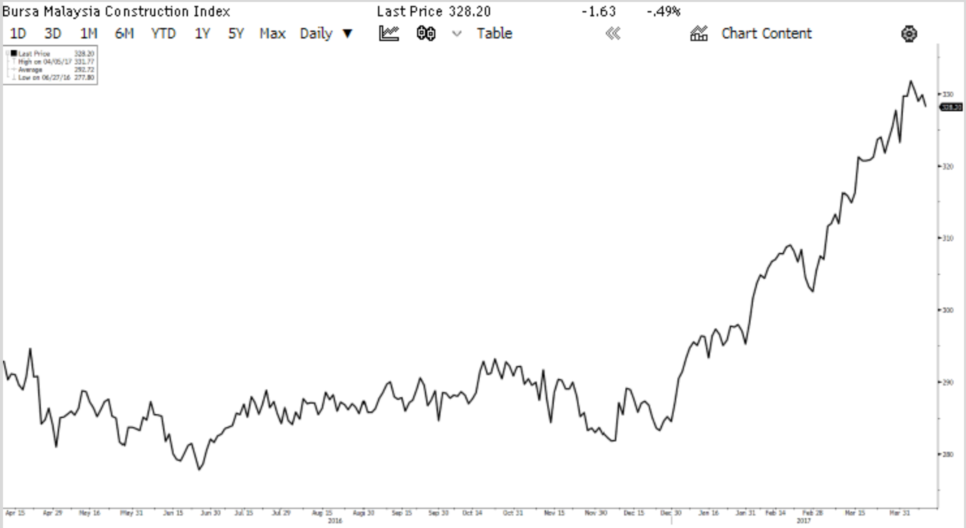

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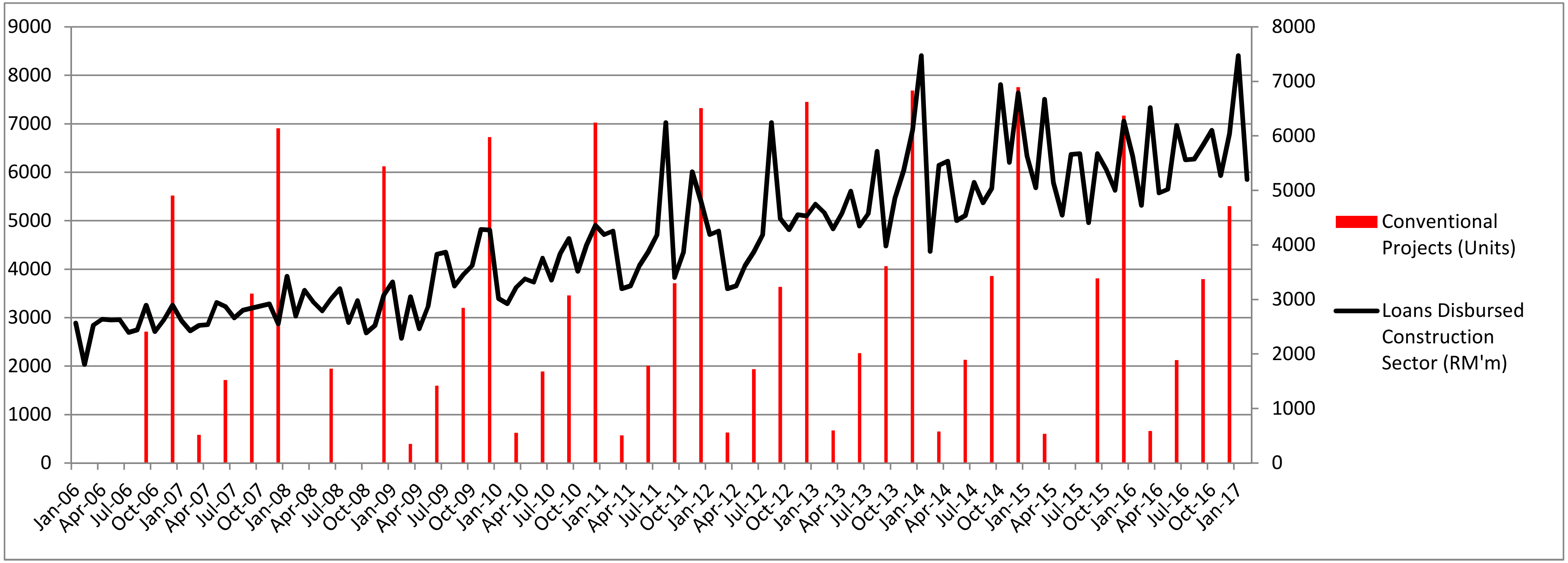
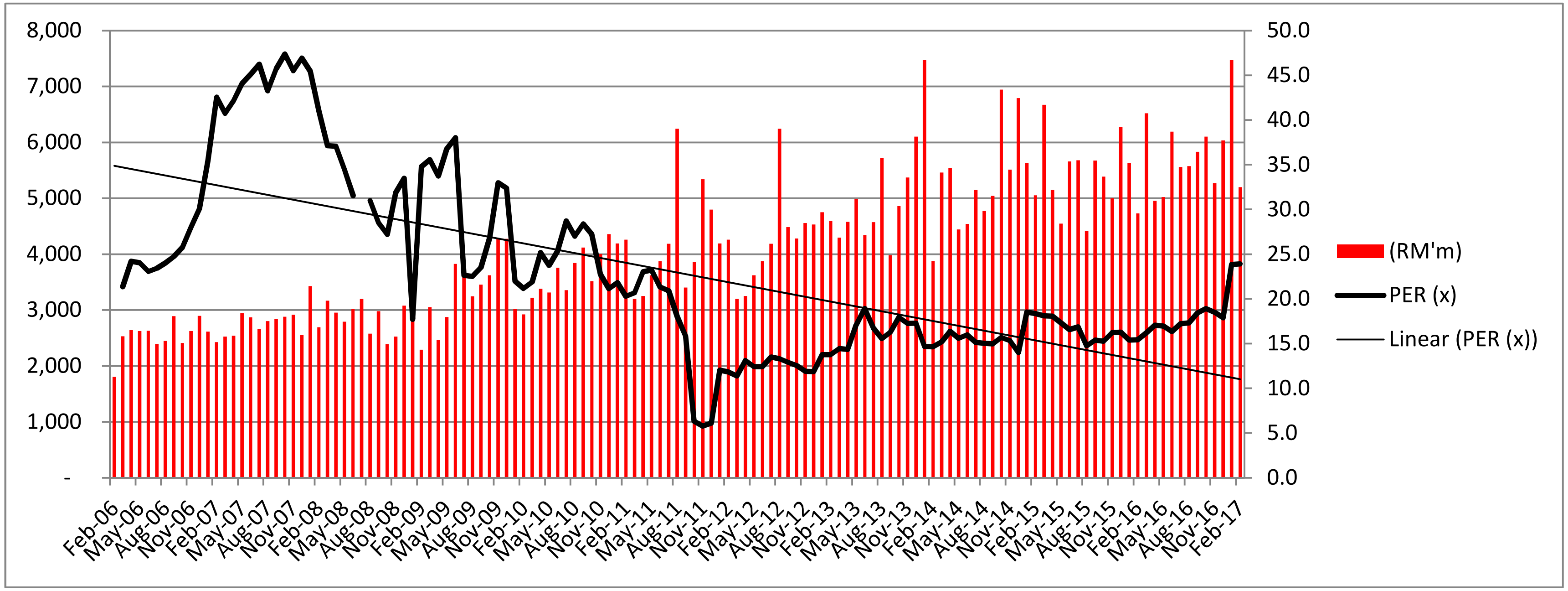
FIGURE 1: PROJECTS VS. CONSTRUCTION LOANS DISBURSED



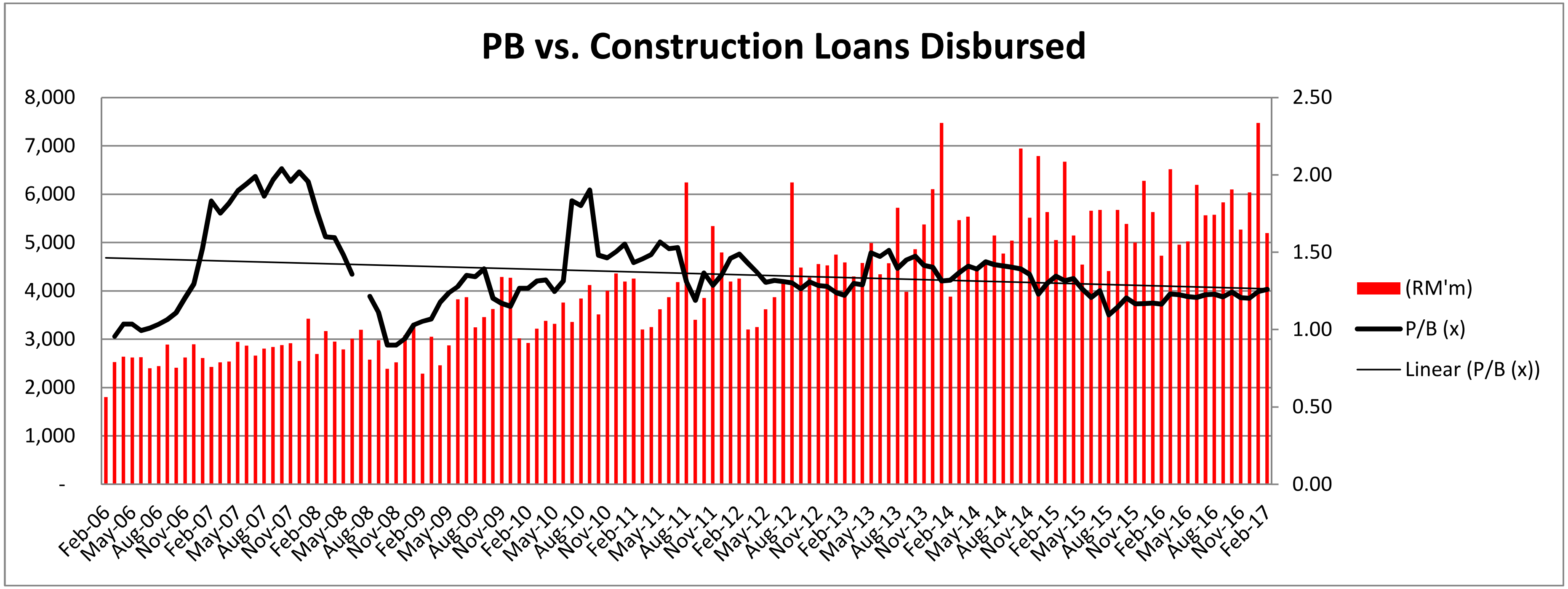
Source: CEIC, DOS, CIBD

FIGURE 2: PER VS. LOANS DISBURSED



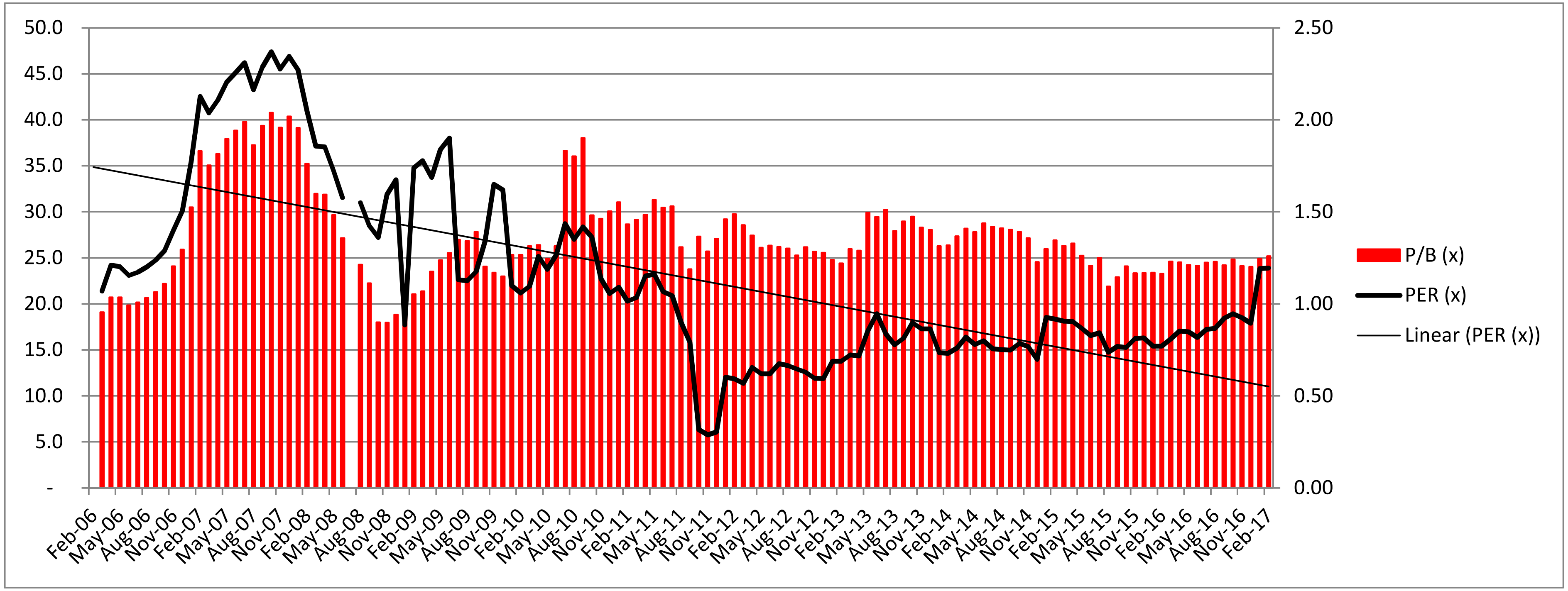
Source: CEIC, DOS, CIBD

FIGURE 3: KLCON PB/R RATIO VS. LOANS DISBURSED



Source: CIDB, Bloomberg & DOS

FIGURE 4: KLCON PB/R AND PER CONVERGENCE



Source: CIDB, Bloomberg & DOS

FIGURE 5: EARNINGS YIELD

Company (YTD)	P/BR (x)	PER (x)	Sales Growth (%)	Earnings Yield (%)	5-Y MGS (%)	Spread (%)
MRCB	1.35	11.5	165.7	8.63	3.86	4.77
MUHI	1.24	11.4	49.5	8.81	3.86	4.95
IJM	1.32	26.1	10.8	3.83	3.86	-0.03
GAM	1.65	18.9	61.8	5.27	3.86	1.41
CMS	2.03	26.6	-11.4	3.75	3.86	-0.11
HSL	1.30	16.0	-29.3	6.18	3.86	2.32
VIVO	1.21	9.34	-24.2	9.7	3.86	5.84
SCGB	4.51	18.0	-6.67	5.55	3.86	1.69
WCTHG	0.85	35.3	-13.2	2.91	3.86	-0.95
AQRS	1.24	18.9	21.1	5.34	3.86	1.48
KLCON	1.27	24.3	***N/A***	4.1	3.86	0.24

Source: Bloomberg

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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.