

## THEMATIC REPORT | Malaysia Construction

**Towards Better Sarawak 2030**

**Authors:**  
Danial Razak  
Muhammad Zafri

- *Utilizing its abundant cash reserves for planned developments*
- *The target is to reach higher accessibility for electricity and water coverage, as well as extensive road networks*
- *Development projects are expected to materialize in the immediate term*
- *The incoming heavyweight projects are dubbed as Second Trunk Road, Coastal Roads and State Water project*
- *Huge beneficiaries are the state's local companies*

**Construction contribution to Malaysia GDP has been growing**, which we observed being underpinned by private investments. However, we noted that trend is declining, as private and public investments tapered in recent years. In terms of sector's valuation, it was seen falling immensely, in the greater part of 2018 following a series of construction news deemed negative by investors. Largely, sentiment turned negative due to possible postponement and cancellation of huge scale railway projects, namely LRT3, MRT2, HSR and ECRL to name a few.

**In the near term, we expect fundamentals to advance gradually.** We believe convergence to the whole market index (KLCI) is likely, driven by the sector's long-term prospect, declining material prices, and improved sentiments. Our view was predicated on KLCON's recent troughs level, signalling that the worst had been priced in. In the near term, recovery in fundamentals could be gradual as local contractors have to recognize the costs for delays and narrowing cash flows.

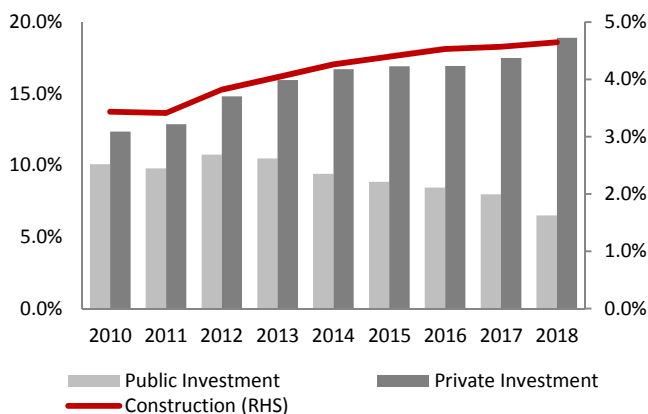
**Unmasking potential at company-specific level.** In current situation, we favour stocks which could offer clearer prospect in the immediate term. This would mean identifying companies with steady growth potential and resilient core business to mitigate the impact from short-term swing in business environment.

**Immediate prospect looks brighter in Sarawak companies.** The state government has recently announced a record budget of RM9.1b for development. Accordingly, the amount will be utilized to fund few major infra projects including the Coastal Road, Second Trunk Road and the Water Grid Project. Approximately 67 per cent of the RM9.1b allocation for development expenditure (DE) will go to the development of rural areas. Note that the RM9.1b allocated for DE is also the biggest in the history of Sarawak, since the previous budgets for 2017 and 2018 allocated only RM2.982 billion and RM3.062 billion respectively.

**In light of these announcements in Sarawak**, we opine that companies with strong track record in Sarawak will benefit. Given the timeline and scope of these projects, we recommend investors to consider local companies like **Cahaya Mata Sarawak (BUY, TP: RM4.13)** and **KKB Engineering (BUY, TP: RM1.35)**, which we opine are front-runners for the pending roll-out of the infrastructure projects aforementioned.

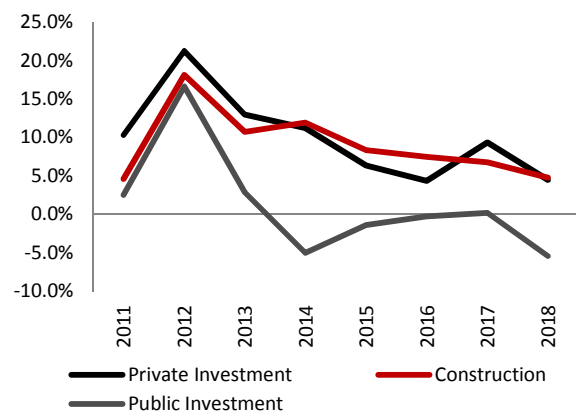
**Overview on construction in Malaysia.** Share of construction sector to Malaysia's GDP increases modestly during post-GFC period. 3.4% in 2010 risen to 4.6% in 2018. The rising construction share is in tandem with the contribution of private investment, 12.4% to 18.9% within eight years. However, the growth rate of construction sector has been on declining trend since 2012 as investments of private and public tapering down. Following the oil price plunge in 2014, government investment contracted for 3-consecutive years from 2014 to 2016. Following the change of Malaysian government on 9<sup>th</sup> May-18, government-backed infrastructure projects particularly railways had to be postponed and put under revision by the new government. In 2018, public investment returned to contraction at -5.4% and construction sector grew at 7-year low of 4.8%.

**Chart 1: GDP Share of Construction & Investments (%)**



Source: CEIC, MIDFR

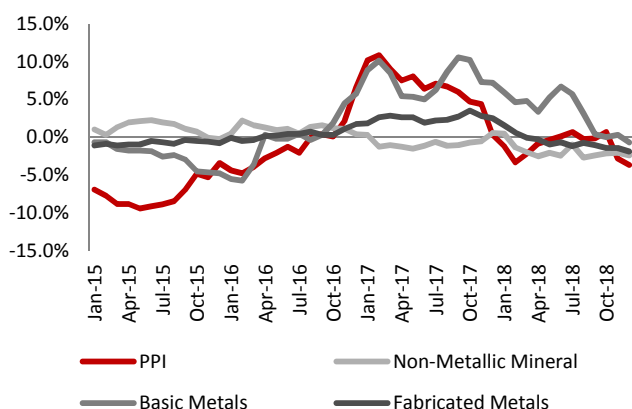
**Chart 2: Investments vs Construction (YoY%)**



Source: CEIC, MIDFR

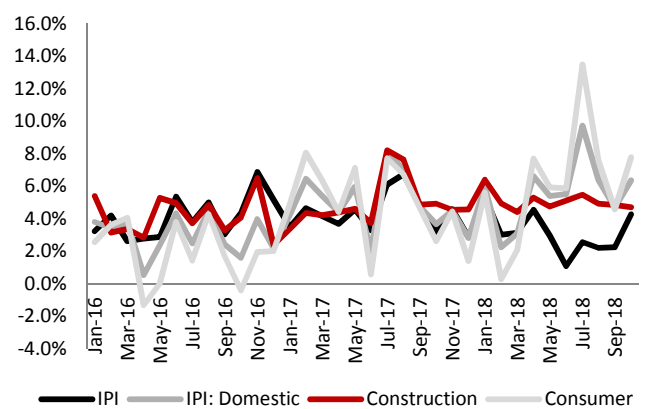
**Declining inflation for construction materials.** Together with overall PPI performance, input cost for construction materials declined last year. Overall PPP contracted -1.1%, non-metallic mineral and fabricated metals fell -1.9% and -0.6% respectively in 2018. Cost of basic metals up 3.3%, lower than 2017's average of 7.8%. The significant decline was seen in 2H18 as the government announced zero-rated GST and stabilised retail fuel prices especially RON95 and Diesel at RM2.20 and RM2.18 per litre respectively. Starting 1st Jan-19, the fuel price mechanism returns to floating regime but capped at RM2.20 and RM2.18 if global oil prices spike. Henceforth, low inflation factor would support construction sector to expand at faster pace in 2019.

**Chart 3: Overall PPI vs Construction Materials (YoY%)**



Source: CEIC, MIDFR

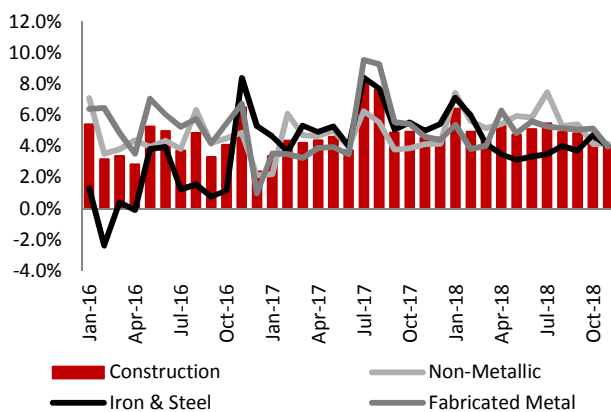
**Chart 4: IPI Growth on Construction (YoY%)**



Source: CEIC, MIDFR

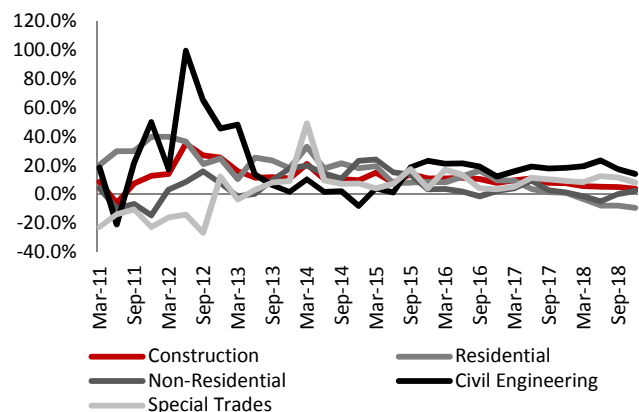
**Construction IPI outperformed average.** From 2016-2018, IPI growth for construction sector has always above than overall IPI performance. For instance, construction IPI grew 5% against overall IPI 3.1% in 2018. The strong growth is mainly contributed by productions of non-metallic mineral, iron & steel and fabricated metal. By work done, Malaysia's construction sector is gradually shifting its focus from non-residential to civil engineering. In 2010, 44.5% contributed by non-residential, 25.9% by civil engineering, 20.3% by residential and 9.3% by special trades. In 2018, share of civil engineering surged to 41.6%, non-residential held lesser to 28.3%, residential 25.1% and special trades 4.9%. Overall work done of construction increased 5.1% last year, lowest since 2010. The slowdown was purely due to contraction in both residential and non-residential by -7% and -0.8% respectively. Meanwhile, civil engineering continued expanding on robust pace of 18.8% in 2018, recording four-consecutive years of double digit growth speed.

**Chart 5: IPI Growth on Sub-Construction (YoY%)**



Source: CEIC, MIDFR

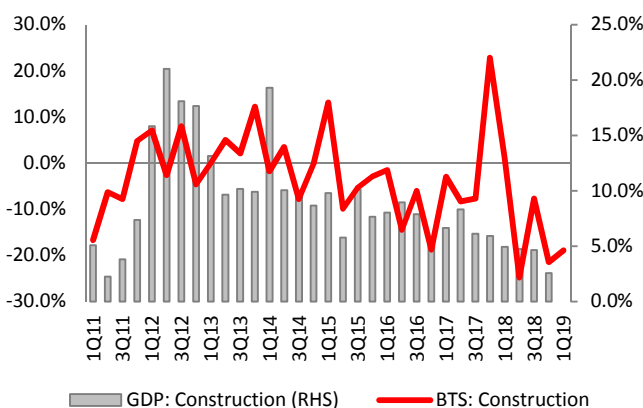
**Chart 6: Construction by Work Done (YoY%)**



Source: CEIC, MIDFR

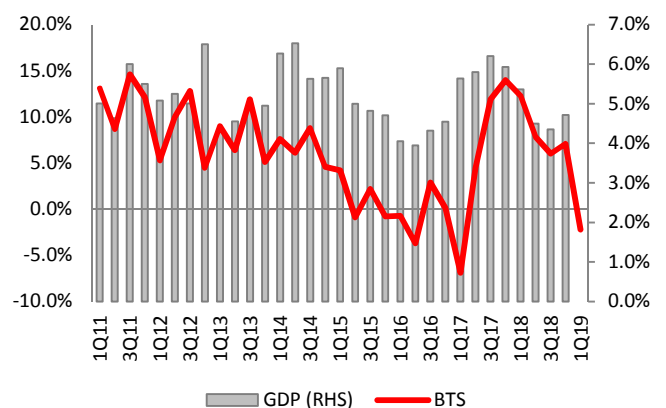
**Construction stays gloomy for 4 consecutive quarters.** Business confidence in construction sector remains in negative territory since 2Q18. Revision of government-backed infrastructure projects and fiscal consolidation as mentioned in the Budget 2019 are among factors for the continuous pessimism in the sector. Nevertheless, we opine confidence in the sector will rebound should the government confirms to revive the ECRL project. In addition, recent announcement by the Sarawak Chief Minister of RM9.1b allocation for infrastructure projects in the state would fuel optimism in the sector.

**Chart 7: Construction: BTS (%) vs GDP (YoY%)**



Source: CEIC, MIDFR

**Chart 8: BTS (%) vs GDP (YoY%)**

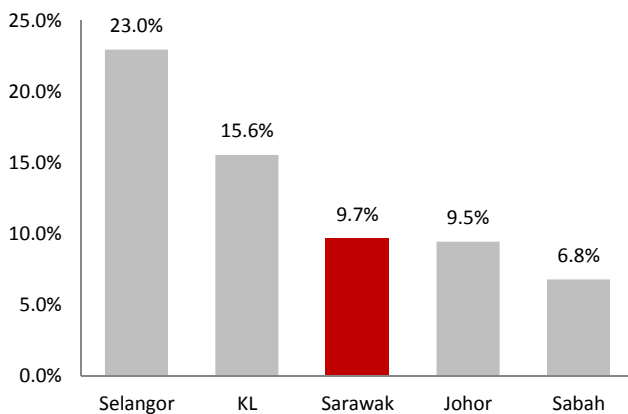


Source: CEIC, MIDFR

**We visited Sarawak on 10-11th April 2019.** The purpose was to learn more about the state’s macro direction as well as its plan for future developments. We observed that its near-term plan is exciting, as the state prioritizes on huge scale electricity, water and road projects. Given the need-based nature of aforementioned agendas, we opine that the implementation is timely and strategic in favour of its local residents and businesses.

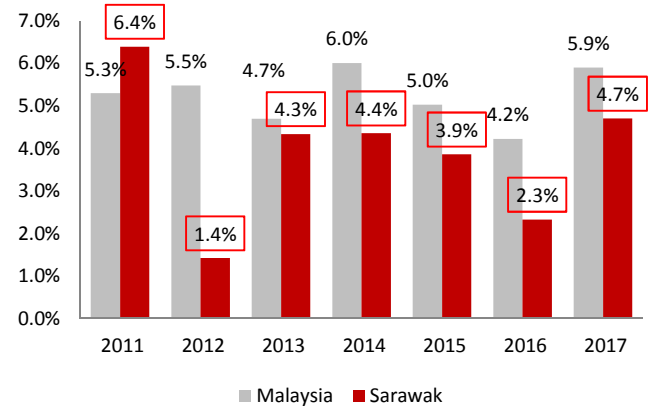
**Sarawak the 3<sup>rd</sup> largest economic contributor.** Sarawak’s contribution towards national GDP is the highest after Selangor & Kuala Lumpur. By 2017, for every RM1 generated in Malaysia, almost 10 cents contributed by Sarawak. Post-GFC’09, Sarawak’s economy expands on average of 3.9% per annum, higher than the target set in the Midterm Review of 11<sup>th</sup> Malaysia Plan, 3.5%. However, out of seven years, only in 2011 Sarawak’s GDP growth surpassed national growth rate. Moving forward, we view Sarawak economy has larger rooms to grow especially with better infrastructure and connectivity such as roads, railways and other development enablers.

**Chart 9: Percentage Share (%) to National GDP in 2017**



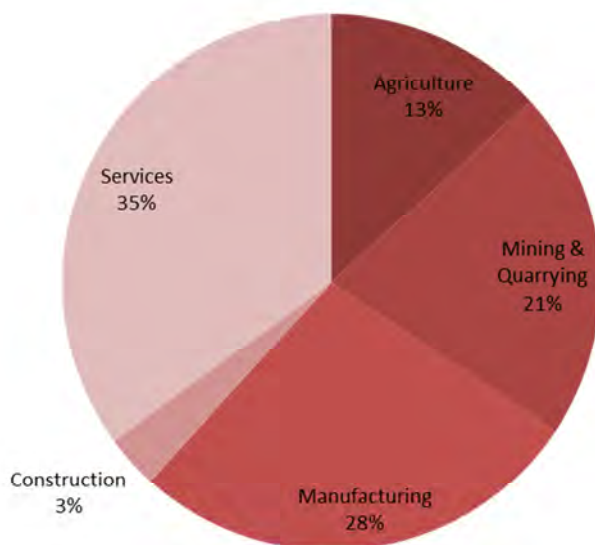
Source: CEIC, MIDFR

**Chart 10: Annual % Growth Sarawak vs Malaysia**



Source: CEIC, MIDFR

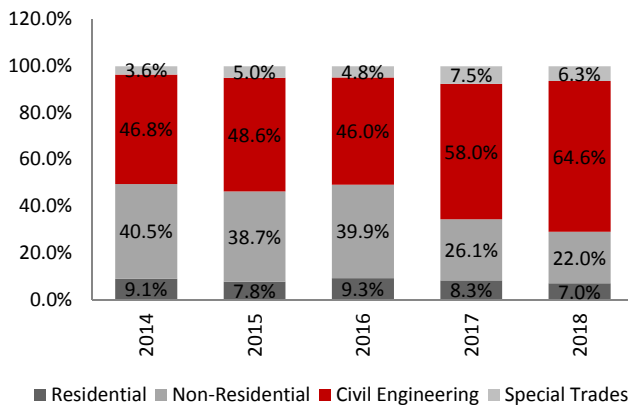
**Chart 11: Sarawak GDP Distribution by Economic Activity**



Source: SPU, MIDFR

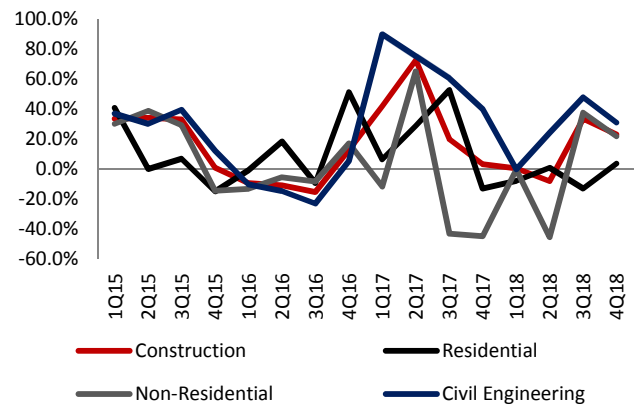
**Pan-Borneo Highway drives up construction activity.** Share of civil engineering activity in Sarawak increased significantly since 2017 following the construction of Pan-Borneo Highway among others. Civil engineering is defined as construction of road & railways, utility projects and non-building projects. The construction component has taken up larger share to almost 65% in 2018. In a simple word, for every RM1 construction output in Sarawak, 65 cents is for civil engineering works. Nevertheless, we foresee the construction of residential and non-residential to pick-up in the long term particularly with better infrastructure and more diversified economic activities.

**Chart 13: Share of Construction Activity in Sarawak (%)**



Source: CEIC, MIDFR

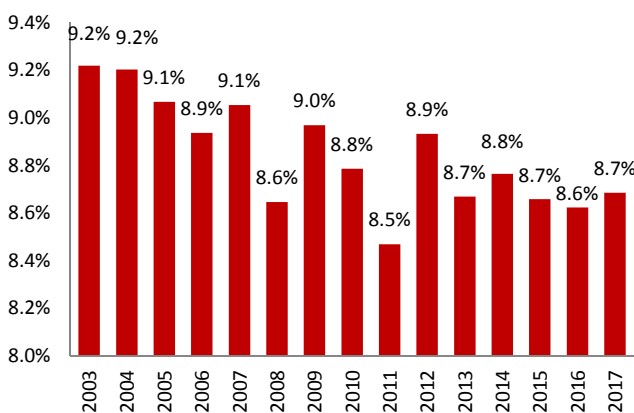
**Chart 14: Construction in Sarawak (YoY%)**



Source: CEIC, MIDFR

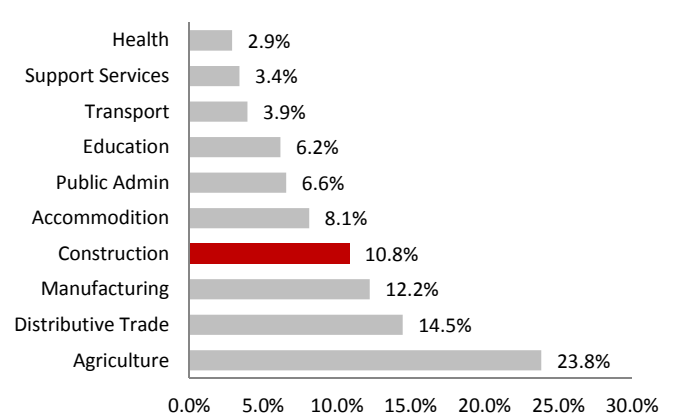
**Construction employment on the rise.** In 2017, almost 11% of employment in Sarawak goes to construction sector. By national contribution, Sarawak supports similar 10.8% of total construction employment. The sector's job market has been on steady pick-up, thanks to Pan-Borneo Highway and other infrastructure projects. In fact, the employment in Sarawak grew faster than Malaysia's construction employment during post GFC'09, 4.7% vs 3.2% per annum.

**Chart 15: National Employment Share of Sarawak (%)**



Source: CEIC, MIDFR

**Chart 16: Sarawak's Employment by Sector Share (%)**



Source: CEIC, MIDFR

**Nearly 50% of Pan Borneo Highway ("PBH") Sarawak project is completed.** According to SPU, the current progression is at 45%. Hock Seng Lee, KKB Engineering and CMS are among the contractors involved in the construction work of PBH. Upon checking, we learned that the progress rate of their packages is in the range of 40-45%, as well. In recognition of this, the entire stretch is expected to complete by CY21, before the state election. The deadline for state election is June 2021, which means that the work package contractors still have 27 months left to complete the remaining job. While the works seem to be progressing well, we take note of the concerns on PDP model adopted for PBH. According to SPU, the matter was non-issue for Sarawak portion as the projects were carried out in prudent manners. Hence, they are not expecting any material change to the current construction format.

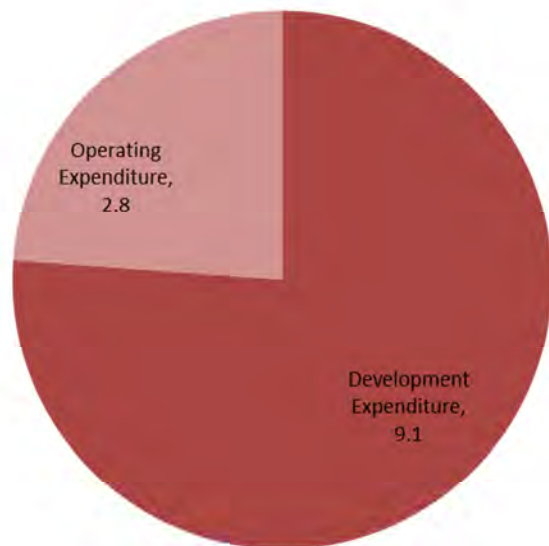
**Chart 17: Pan Borneo Highway Sarawak Map**



Source: LBU, MIDFR

**Allocation for state development is the highest in 2019.** RM9.1b was allocated by the state government for the development of infrastructure throughout Sarawak. The amount covers the expansion of water and electricity coverage (especially in rural areas), amounted to RM2.8b and RM2.3b respectively. The total amount was also budgeted for the upgrading and construction of paved roads.

**Chart 18: Sarawak State Budget 2019 (RM'b)**



Source: SPU, MIDFR

**Sarawak Water Supply Grid Programme (“SWP”).** Out of RM9.1b allocated, RM5.2b was meant for the development of utility services in the rural areas (with RM2.8 billion for water supply and RM2.37 billion for electricity). SWP is very much focused on laying and replacement of pipelines, construction of booster stations, upgrading and improvement of water treatment plants, digitalization of water supply and improvement works to existing water supply system. The project is under the purview of Minister of Utilities, which has set target completion in CY20. We understand that the RM2.8b is budgeted for the first phase, which comprises over 251 projects at various locations, with a total scheme value of RM3.92 billion. Based on our channel checks, 249 projects are scheduled to be completed by the year 2020 and two projects slightly beyond. Up to date, five projects have been completed and 24 projects are currently under construction. According to SPU, the SWP tenders are open to all, which gives an advantage to contractors and suppliers of water pipes who have good track record. We note that preferential treatment will be given to local players.

**Table 1: Sarawak Consumption and Production of Water**

Particulars	2015	2016	2017	2018A	2019F	2020F
Production ('000 cu. Metres)	452,454	476,822	505,590	594,718	651,463	713,623
Consumption ('000 cu. Metres)	305,867	311,653	327,572	406,572	447,032	491,519
Consumption/Production	67.6%	65.4%	64.8%	68.4%	68.6%	68.9%

Source: SPU, MIDFR \*Forecasts were based on 3-year CAGGR

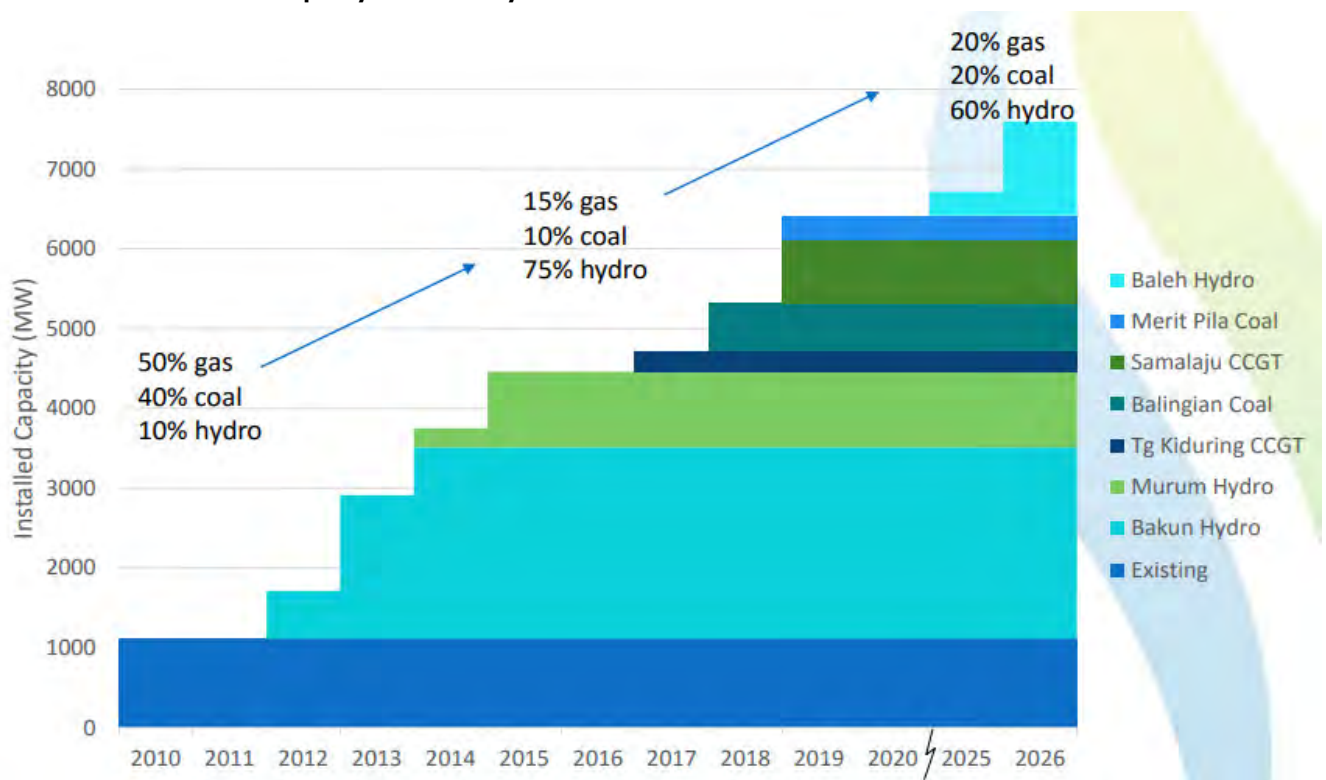
**Towards 99% electrification rate in Sarawak.** As of 2017, the coverage is at 95% with the current total generation capacity of 4,701MW. Additionally, Sarawak has set a near-term target of 97% electricity coverage in 2020. Accordingly, the state has allocated RM2.3b for the development of the state's electricity services, spread out for the next two years. We understand that Sarawak Energy Berhad ("SEB") which was delisted in 2010, owns all the power generating assets in Sarawak. In recognition of this, the future electricity supply is highly dependent on the generation capacity of SEB. Based on our meeting with SEB, the utilization of its plant has been maxed out. To break it down, total utilization is at 80% of capacity. The remaining 20% is reserved for safety and emergency purposes. While SEB generation power is constrained by its current size, we learned that the construction of new power plants are underway. This includes Balingian Coal-Fired Power Plant (624MW), Tanjung Kidurong Combined Cycle Power Plant (421MW x 2 Blocks) and Baleh HEP (1,285MW). The earliest to commence operation is the Balingian Plant which is in 2019.

**Table 2: Sarawak Unit Generated and Consumption of Electricity**

Particulars	2015	2016	2017	2018A	2019F	2020F
Unit Generated (million KWH)	16,748	25,573	26,837	27,544	32,513	38,377
Consumption (million KWH)	15,536	22,185	25,468	26,254	31,272	37,248
Consumption/Unit Generated	92.8%	86.8%	94.9%	95.3%	96.2%	97.1%

Source: SPU, MIDFR \*Forecasts were based on 3-year CAGGR

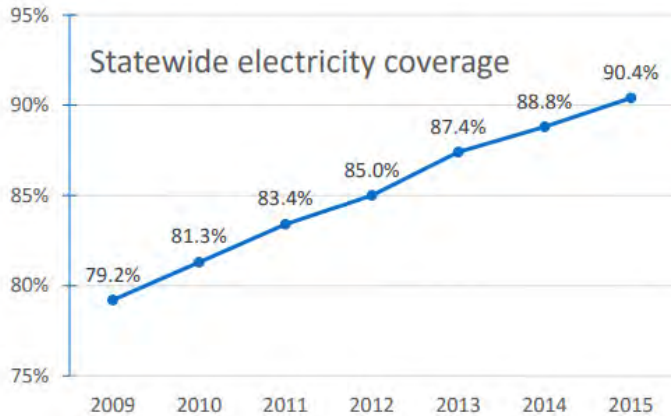
**Table 3: Sarawak Installed Capacity for Electricity**



Source: SEB



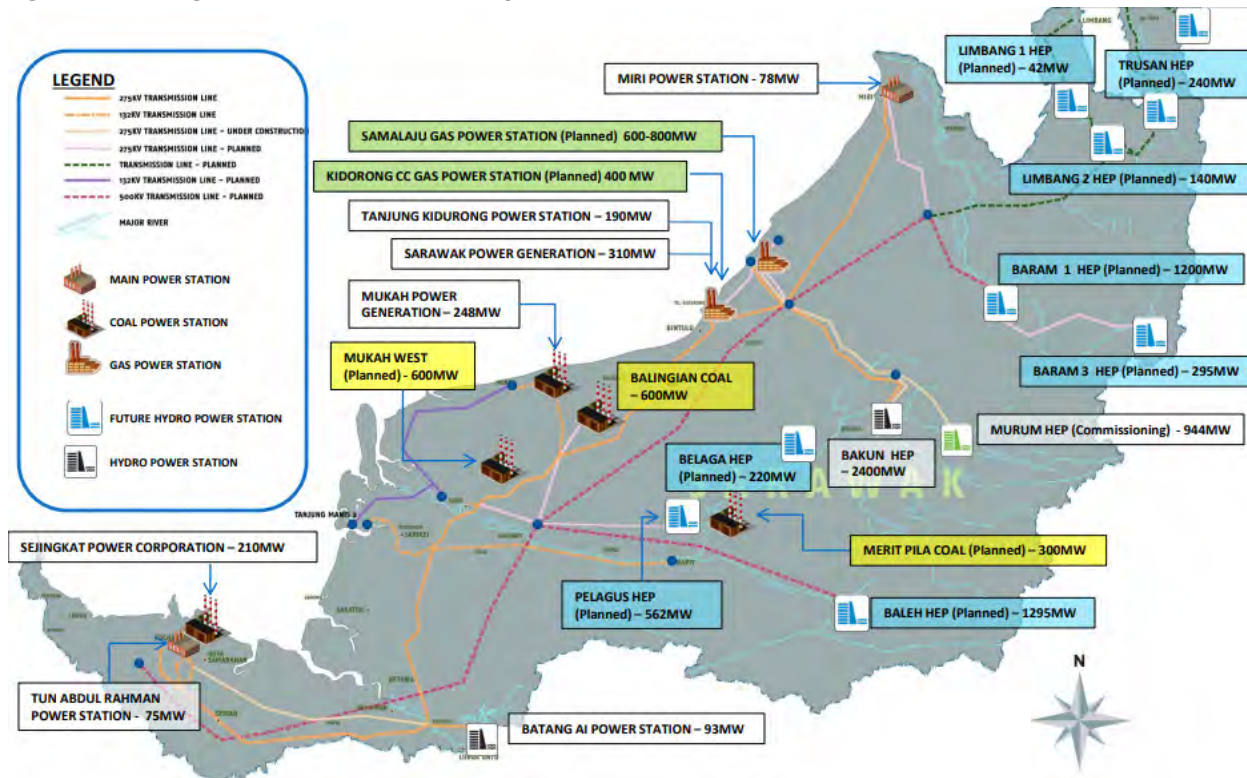
**Figure x: Rural Electrification Achievements 2009-2016**



Yet to be electrified	Villages	Households
Accessible	556	9,567
Need access	916	17,603
Remote	397	11,321
<b>Total</b>	<b>1,869</b>	<b>38,491</b>

Source: SEB

**Figure 1: Building SCORE; Possible Scenario up to 2035**



Source: SEB

**More road projects to come.** On top of Pan Borneo Highway, new roll-outs for Sarawak road works are Second Trunk Road and Coastal Road. Both projects are estimated to carry construction value worth of RM6b and RM5b respectively. Some parts of the Coastal Road are already completed, hence the new roll-outs mainly comprised of construction of missing links along the highways.

**Background on Coastal Road...** The coastal highway project is planned to connect Sematan in the south to Miri in the north, covering a distance of about 900km which will also involve the construction of 11 bridges. We noted that the main components of the coastal road are Btg Saribas bridge, Btg Rajang bridge including a 17km access road, Sungai Krian bridge, Btg Paloh bridge, Muara Lasa bridge and Bintulu Jepak bridge which are all funded by the state government. Completion is expected in ten years' time with construction value estimated at RM5b. Upon completion, the highway is expected to provide seamless driving experience from Sematan right up to Miri.

**... and Second Trunk Road.** The Second Trunk Road highway will serve to provide alternative shorter routes to the main trunk road, Pan Borneo highway and the coastal road network. The first section of the second trunk road is from Kota Samarahan to Roban, covering a distance of about 112km of single carriageway JKR R5 two-lane highway. The last section of about 30km includes the upgrading of the existing Jln Kelupu-Jln Tanjung Gunting to Lanang bridge in Sibul from two lanes to four lanes JKR R5 highway. Upon completion, the highway is said to reduce the travelling time from Sibul to Kuching by two and half hours (in comparison to Pan Borneo Highway, which will take five to six hours). According to a source, the Second Trunk Road will comprise three packages from Kota Samarahan to Roban, from Sebuyau to Sri Aman and Betong and from Jalan Kelupu/Jalan Tanjung Genting to Lanang, Sibul. The estimated cost of second trunk road is RM5b-RM6b. Both projects namely Coastal Highway and Second Trunk Road are expected to commence by 1HFY19.

**Potential plays into the theme.** We opine that companies with strong track record in Sarawak will benefit. Given the timeline and scope of these projects, we recommend investors to consider local companies like **Cahaya Mata Sarawak (BUY, TP: RM4.13)** and **KKB Engineering (BUY, TP: RM1.35)**, which we opine are front-runners for the pending roll-out of the infrastructure projects aforementioned. Cahya Mata Sarawak is the sole cement supplier in Sarawak, with capacity of offering full range construction services. The strategic location of its construction materials plants across Sarawak will put it ahead against competitors, to benefit road construction projects. KKB Engineering stands a good chance of winning some contracts from the water projects, due to its long track record in pipe manufacturing and supplies. The company currently sits on approximately RM146.0m of cash reserves, which place it in the healthy territory to clinch and operate new projects successfully. We would not rule out **Hock Seng Lee (NEUTRAL, TP: RM1.54)**, as it will likely put in a bid for the planned infra works as well. In recognition of this, HSL's tender book for water projects could comprise of jobs involving the construction of treatment plant, water tank and reservoir as well as pipe laying works.

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#### STOCK RECOMMENDATIONS

BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +15% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >10% 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.