UOBKayHian

Regional Morning Notes

Tuesday, 12 July 2022

SECTOR UPDATE

Construction – Malaysia

Positioning For A More Meaningful Recovery In 2023

The sector is expected to see a gradual recovery continue in 2H22, following healthy yoy earnings growth in 4Q21 and 1Q22, driven by accelerated progress billings. Labour shortage and higher building materials cost will continue to pressure the recovery momentum. More meaningful recovery will be seen in 2023, supported by the roll-out of infrastructure projects and higher productivity levels from the easing of the labour shortage. Maintain MARKET WEIGHT. Top picks: Gamuda and Kerjaya Prospek.

WHAT'S NEW

- **Gradual recovery continues in 2H22.** While headwinds such as the labour shortage and inflation may pressure margins this year, we still expect sector earnings to improve yoy, backed by the accelerated progress billings after the lockdown measures were lifted. For companies under our coverage, we forecast earnings growth of 24.4% and 27.9% in 2022 and 2023 respectively. The sector's progress billings have picked up since 4Q21 after construction activities were allowed to resume from mid-Aug 21. We saw a yoy recovery in construction earnings in 4Q21 and 1Q22. Thus far in 2022, there has been more clarity on the timeline for the roll-out of mega projects such as MRT3 and implementation of Pan Borneo's remaining packages. In 4M22, about 30% (RM23.2b) of the RM75.6b (21.9% yoy) development expenditure from Budget 2022 was utilised, and the remainder will be rolled out in 2H22.

- **1Q22 results round-up.** Generally, 1Q22 earnings of the construction companies under our coverage were 50:50 split between within and below expectations. Overall earnings improved yoy with higher productivity after the lockdown was lifted, but on a quarterly basis, margins were pressured mainly by higher building materials costs amid rising inflation globally. Construction progress continues to be pressured by the ongoing labour shortage. For some contractors, higher-than-expected margins from their near-to-completion projects helped to partially offset the impact of rising operating costs.

- **Government support to alleviate rising cost pressure.** In May, the Ministry of Finance (MOF) announced that the Variation of Price (VOP) clause will be extended for all government-related projects to ensure that they are completed on time. This means that the government will continue to partially cover increases in materials costs until the projects are completed, but the VOP is applicable only to projects that were awarded between Jan-Jun 22. For example, companies like GAQRS may be able to recoup as much as RM20m-30m for projects such as PPSAS and LRT3. Other construction players such as Suncon are in the midst of submitting their claims.

ACTION

- **Maintain MARKET WEIGHT.** There is still a lack of visibility in terms of execution details on the roll-out of mega projects amid the political climate and fiscal constraints. This could be cause for concern, especially for contractors that rely heavily on government projects. We believe there will be more clarity after the general election is held sometime at end-22 or in 2023. Property sales growth may be muted this year given the unfavourable macro environment. Elevated building materials costs and the labour shortage also will continue to pressure on earnings growth in 2H22. However, the sector is trading at around 0.7x P/B or -1SD to its 0.93x five-year historical mean, reflecting the sector's uncertain prospects. We have BUY calls on Gamuda, Kerjaya, GAQRS and WCT.

MARKET WEIGHT

(Maintained)

SECTOR BUYS

Company	Rec	TP (RM)
Gamuda	BUY	4.09
Kerjaya Prospek Group	BUY	1.44
Gabungan AQRS	BUY	0.56
WCT Holdings	BUY	0.68

Source: UOB Kay Hian

1Q22 RESULTS SUMMARY

Company	Revenue (RMm)	Core net profit/(loss) (RMm)	vs. UOB	vs. consensus
GAMUDA*	1,180.6	221.5	Above	Above
GAQRS	71.7	8.4	Below	Below
IJM**	1,232.5	126.1	Within	Within
KERJAYA	300.6	28.9	Below	Below
MRCB	810.7	14.0	Within	Within
SCGB	624.7	34.2	Within	Within
WCT	604.7	(25.0)	Below	Below

**FYE July, based on 3QFY22 results **FYE Mar, based on 4QFY22 results. Source: Respective companies, UOB Kay Hian*

CCONSTRUCTION FIRMS' EARNINGS TREND

Source: Respective companies, UOB Kay Hian

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PEER COMPARISON

Company	Tickers	Rec	Share Price 8 Jul 22 (RM)	Target Price (RM)	Market Cap (RM)	PE FY22F (x)	PE FY23F (x)	P/B FY22F (x)	P/B FY23F (x)	ROE FY22F (%)	ROE FY23F (%)
Kerjaya Prospek Group	KPG MK	BUY	1.11	1.44	1,400	11.7	10.0	1.0	0.9	11.0	12.1
WCT Holdings	WCTHG MK	BUY	0.49	0.68	624	12.7	5.9	0.3	0.2	2.6	3.6
Gamuda	GAM MK	BUY	3.34	4.09	9,066	12.2	11.4	0.8	0.7	7.8	8.3
Gabungan AQRS	AQRS MK	BUY	0.33	0.56	174	4.3	3.3	0.3	0.2	3.5	10.7
IJM Corporation	IJM MK	HOLD	1.54	1.65	5,961	19.6	17.3	0.5	0.4	1.6	2.7
Malaysian Resources Corp	MRC MK	HOLD	0.35	0.37	1,541	25.7	18.1	0.3	0.3	0.8	1.0
Sunway Construction Group	SCGB MK	HOLD	1.59	1.57	1,921	15.1	13.4	2.3	2.2	18.4	19.2

Source: Bloomberg, UOB Kay Hian

- **Our top pick: Gamuda (GAM MK/BUY/Target: RM4.09).** Gamuda stands to be the prime beneficiary of the upcoming roll-out of mega infrastructure projects in Malaysia, especially MRT3, given its deep rail-related expertise. Gamuda is also transforming into a major regional player following its recent job wins worth over RM9b in Australia, Singapore and Taiwan.

ESSENTIALS

- **Prolonged rising inflation may dampen recovery.** In 2Q22, steel and cement prices remained elevated at >RM3,500/mt (+12% qoq) and >RM300/mt (+15% qoq). We believe this will impact margins in the near term as companies may be unable to fully pass on the sharp rises in costs, either due to competition or prior locked-in contract terms, especially for ongoing projects. Some projects may also be potentially delayed due to the increase in materials cost. However, we foresee prices easing gradually, given the weak market sentiment and supply recovery as reflected by the downtrend in China's steel prices (-3% mom) and coal prices (-26% mom). High margins from the reversal of contingency provisions for some projects that are reaching their tail-end projects ie LRT3 and MRT2 will help to cushion the impact. Moreover, some outstanding projects have completed most of their civil works. Some industry players have also factored price increases into their new tenders to avoid margin erosion.

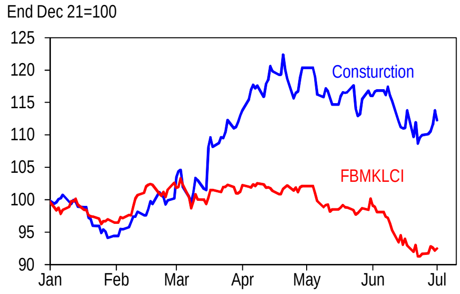
- **Labour shortage continues to put pressure…** While local constructions companies may see a gradual inflow of labour in 2H22, we believe that the shortage of labour may only be fully resolved in 2023. This is mainly due to the lengthy processes required and competition with other sectors to secure the incoming foreign workers. There were 475,678 employers that have applied for recruitment of foreign workers as of 1 April, according Malaysian Employers Federation (MEF). The construction sector accounted for about 9% of the applications. The approval rate of 0.55% for these applications is worrying, as it reflects that the issue will take much longer time to be resolved.

- **…on companies' productivity levels.** According to the Department of Statistics Malaysia (DOSM), the value of construction work done in Malaysia in 1Q22 was RM29.5b, which is 16% lower than pre-pandemic level. Commencement of new construction projects also has been slow with only 5% contribution to the total works. The private sector remains as the biggest contributor with about 61%. Geographically, Selangor and Wilayah represented the most, accounting for around 43% of the total work done. Note that the government projects the construction sector's output to grow by 11.5% yoy this year.

- **MRT3 is on track.** Ytd, MRT Corp has been hitting the required milestones in a timely manner, in terms of the tendering process. Most major construction companies are eyeing the three civil packages: a) Civil Package 1 (CP1) , b) Civil Package (CP2) of the elevated portion (~RM14b), and c) Civil Package 3 (CP3) - tunnelling job (~RM11b). For the elevated part, CP2 may offer a higher value of around RM12b, involving a 27km elevated section and 1.2km of ground tunnels vs CP1 that may be worth about RM2b, consisting a 6km elevated section including the main depot. CP3 involves a 6km elevated section and 10km underground portion. Jobs are expected to be awarded in 4Q22. Among the potential beneficiaries are companies with a strong track record in railway projects and robust balance sheets, such as Gamuda, MMC, GAQRS, IJM, Suncon, WCT, MRCB, Kimlun and Econpile. With the private finance initiative (PFI) structure, contractors will have to fund at least the first two years (about 20% of the job value) due to the country's limited fiscal headroom.

- **Highway disposal progressing well.** The shareholders' approvals are expected to be secured in July, which should allow the deal to be completed in August once the RM5.5b sukuk has been successfully raised. The RM2.3b or RM0.91/share that Gamuda may receive from this disposal will be used for reinvestment (19%), special dividends (43%), and reducing borrowings (38%). The funds raised from this disposal will help to deleverage its balance sheet (to change it to a net cash position of >RM1b).sd There are also some new highway jobs in the private sector such as the Petaling Jaya Dispersal Evelated Highway (PJD Link) (RM3b), the Bangi-Putrajaya Expressway (BPE), Kuala Lumpur Northern Dispersal Expressway (KL NODE), and Sungai Klang Expressway. These new highway projects will not receive any financial assistance from the government as all the costs and risks have to be fully borne by the concessionaires.

CONSTRUCTION INDEX OUTPERFORMED THE FBMKLCI



Source: Bloomberg, UOB Kay Hian

MEGA PROJECTS PIPELINE

Project	Value (RMb)	Remarks
ECRL	50	Status: Reaching 30% completion as of Jun 22. Target to achieve 37% progress in 2022 with expected completion in Dec 26. Potential beneficiaries: IJM Corp (for vertical package); Econpile, Suncon (for horizontal package).
MRT3	30	Status: Cabinet approval on 4 March. Tender opened in May with jobs to be awarded in 4Q22. Potential beneficiaries: Contractors with rail expertise; Gamuda and MMC (underground section), Suncon, IJM, WCT, GAQRS, MRCB.
Pan Borneo Highway Sabah	4	Status: Cabinet approval on 4 March to proceed with the remaining 19 work packages (five years). Phase 1 62% done. Potential beneficiaries: Suria Capital (JV with GAQRS).
Rapid Transit System (RTS)	4	Status: Reached 17% progress as of May 22. Aim to hit 70% by end-23. Expected completion: Jan 2027. Ekovest won RM2b EPC contract. Potential beneficiaries: Subcontract works for rail-related contractors such as Sunway Construction, IJM Corp.
High Speed Rail (HSR)	TBC	Status: Pre-feasibility stage considering a new alignment from Penang or Bangkok to Johor. Malaysia to send new proposals to Singapore on reviving the project.

Source: The Edge, UOB Kay Hian

MRT3 PROJECT DETAILS

Asset Owner	MRT Corporation
Project Period	2023-30 (8 years)
Project Structure	a) 2 contractors for elevated works b) 1 contractor for underground works c) 1 contractor for integrated rail systems d) 1 project management consultant
Estimated Cost	RM30b-50b
Funding Structure	Sukuk issuances and other hybrid funds; every work package will have its own PFI
Length of Alignment	51km: 40km of elevated tracks & 11km of underground tunnels
No. of Stations	31, including 10 interchange stations

Source: MRT Corp, UOB Kay Hian

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