

SECTOR UPDATE

Construction – Malaysia

A Limited Breath Of Fresh Air

While Budget 2023 offers more to the sector as compared with last year, the absence of new mega infrastructure projects in Budget 2023 provides inadequate opportunities for contractors next year. Besides ongoing projects like Pan Borneo, ECRL and RTS, MRT3 is the only new mega project that will be rolled out in 2023. Meanwhile, labour shortage and ongoing inflation may continue to pressure the earnings growth. Maintain MARKET WEIGHT. Top pick: Gamuda.

WHAT'S NEW

- Budget 2023: Implementation of existing projects.** The headline development expenditure (DE) increased to RM95b (+25.7% yoy). The transport sector accounts for the largest share (17) at RM16.5b (+16.7% yoy). Notably, the allocations mostly focused on the ongoing mega infrastructure projects such as: a) Pan Borneo Highway, b) Central Spine Road, c) Gemas-JB Double Track, d) ECRL, and e) RTS Link as well as smaller infrastructure projects in rural areas, especially in Sabah and Sarawak. With only RM250m allocated for the new Public-Private Partnership (PPP) model, we believe this may only benefit bigger players with strong balance sheets as financing for any new mega infrastructure projects would require a high upfront cost from the contractors.
- MRT3 to proceed.** As compared to Budget 2022 where there was no mention of MRT3, Budget 2023 highlighted that the project will cost RM50.2b with projected expenditure of RM3.3b for 2023. Phase 1 is to be completed by 2028, while Phase 2 is slated for completion by 2030. Despite the record-high DE, we reckon that it mainly consists of the allocation for the scheduled repayment of a US\$3b 1MDB bond and potentially reclassification of some operating expenditure as DE. In addition, the DE may also include the spillover of allocation from 2022 as this year's DE was only 50.4%-utilised as of Aug 22. This implies 2023 would continue to offer construction stocks limited new mega infrastructure project opportunities.
- Labour shortage continues to prevail.** According to Department of Statistics Malaysia, the value of construction work done in 2Q22 was RM29.9b (+1.4% qoq, +6.1% yoy), still around 16% lower than pre-COVID-19 levels. The private sector remains the biggest contributor at 58%. Geographically, Selangor, Wilayah and Sarawak continue to represent the most, at around 52% of the total work done. >19,000 foreign workers have arrived in Malaysia since early this year and around 47,000 new ones are expected to arrive soon, according to Malaysian Employers Federation. This is still far from the one million workers required in this country on top of the current 1.4 million.

ACTION

- Maintain MARKET WEIGHT.** The higher DE allocated in Budget 2023 may not translate into more infrastructure spending. As it only focuses mostly on existing projects, the limited new mega projects may not be able to boost the sector's outlook. There is still a lack of visibility in terms of execution details on the mega projects' rollout amid the political climate and fiscal constraint. Elevated building materials costs and labour shortage will also continue to put pressure on earnings growth. 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. Our top pick is Gamuda.

PEER COMPARISON

Company	Tickers	Rec	Share Price 12 Oct 22 (RM)	Target Price (RM)	Market Cap (RM)	PE FY22F (x)	FY23F (x)	P/B FY22F (x)	FY23F (x)	ROE FY22F (%)	FY23F (%)
Kerjaya Prospek Group	KPG MK	BUY	1.16	1.44	1,470	11.7	10.0	1.0	0.9	11.0	12.1
WCT Holdings	WCTHG MK	BUY	0.37	0.56	511	12.7	5.9	0.3	0.2	2.6	3.6
Gamuda	GAM MK	BUY	3.95	4.35	10,340	16.2	14.2	1.0	0.9	7.8	8.2
Gabungan AQRS	AQRS MK	BUY	0.26	0.48	139	4.3	3.3	0.3	0.2	3.5	10.7
IJM Corporation	IJM MK	HOLD	1.58	1.65	5,760	19.6	17.3	0.5	0.4	1.6	2.7
Malaysian Resources Corp	MRC MK	HOLD	0.31	0.37	1,340	25.7	18.1	0.3	0.3	0.8	1.0
Sunway Construction Group	SCGB MK	HOLD	1.48	1.57	1,910	15.1	13.4	2.3	2.2	18.4	19.2

Source: UOB Kay Hian

MARKET WEIGHT

(Maintained)

SECTOR BUYS

Company	Rec	TP (RM)
Gamuda	BUY	4.35
Kerjaya Prospek Group	BUY	1.44
Gabungan AQRS	BUY	0.48
WCT Holdings	BUY	0.56

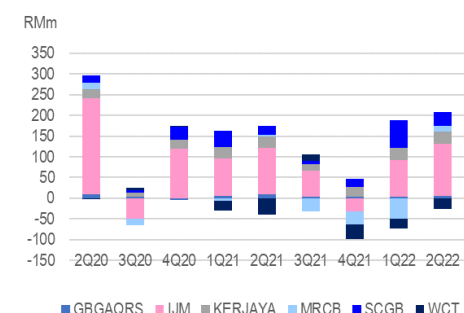
Source: UOB Kay Hian

2022 RESULTS SUMMARY

Company	Revenue (RMm)	Core net profit/(loss) (RMm)	vs. UOB	vs. consensus
GAMUDA*	1,946.6	258.9	Above	Above
GAQRS	79.1	5.9	Below	Below
IJM**	1,072.7	74.5	Within	Within
KERJAYA	276.9	28.6	Within	Within
MRCB	700.4	14.1	Within	Within
SCGB	557.9	32.8	Within	Within
WCT	561.2	(6.4)	Below	Below

*FYE July, based on 4QFY22 results **FYE Mar, based on 1QFY23 results. Source: Respective companies, UOB Kay Hian

CONSTRUCTION FIRMS' EARNINGS TREND



Source: Respective companies, UOB Kay Hian

ANALYST(S)

Hazmy Hazin
+603 2147 1934
noorhazmy@uobkayhian.com

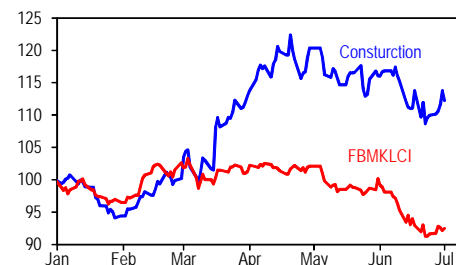
- **Our top pick: Gamuda (GAM MK/BUY/Target: RM4.35).** Gamuda stands to be the prime beneficiary of the upcoming rollout of mega projects in Malaysia, especially MRT3, given its deep rail-related expertise. Gamuda is also transforming into a major regional player following its recent job wins worth over RM9b in Australia, Singapore and Taiwan.

ESSENTIALS

- **Ramp up in flood mitigation projects.** Following the increase in allocation for flood mitigation projects from RM1b/year to RM15b for 2023-30 as announced earlier this year, the government has highlighted in Budget 2023 that an estimated expenditure of RM700m worth of projects are to be awarded in 2023. This includes: a) Sabo Dam project (RM500m) at 46 locations across Malaysia, b) a dual-purpose reservoir (RM2b) in Selangor, and c) additional phase for the Integrated River Basin in Kelantan (RM500m). We believe the dual-purpose reservoir is referring to SMART2 tunnel, for which around eight companies have submitted proposals, including Gamuda, IJM and MRCB. Gamuda has a strong chance of securing the project given its reputable track record in projects like SSP3 and SMART 1 as well as its recently won RM2b Sungai Rasau water plant. Note that the SMART1 project costs around RM1b-2b.
- **East Malaysia: Prime beneficiary of Budget 2023.** Sabah and Sarawak will be receiving higher allocation of RM6.3b (+21.2% yoy) and RM5.4b (+17.4% yoy) in 2023 for building and upgrading water, electricity, road, hospitals, and education facilities. Note that earlier this year, the Cabinet had given its approval to proceed with the 19 work packages involving 367km over five years for Pan Borneo Sabah. The ongoing Phase 1 (15 out of 35 packages) is now over 65% completed (completion date: Oct 24) with Phase 2 expected to kick off next year. Potential beneficiaries of this project are Suria Capital, GAQRS and WCT, in our view. Meanwhile, Phase 1 of Pan Borneo Sarawak comprising 786km is 86% completed. Sarawak will also undertake the Sarawak-Sabah Link Road and the Trans Borneo Highway Project with a ceiling allocation of RM12b for both projects (period: 3-5 years). This will benefit the likes of Cahya Mata Sarawak (CMS), Hock Seng Lee-KKB Engineering, Advancecon, Engtex Group and Fitters Diversified.
- **Prolonged rising inflation may dampen recovery.** In September, steel and cement prices remained elevated at >RM3,600/mt (+6.4% yoy) and >RM350/mt (+10.1% yoy). We believe this will continue to impact margins in the near term as companies may be unable to fully pass on the sharp rises in costs, especially for the ongoing projects. However, we foresee prices easing gradually, given the weak market sentiment amid the rising rates environment and supply recovery as reflected by the downtrend in China's steel prices (-34% yoy). Moreover, some of the 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. The extension of Variation of Price (VOP) clause by the government will also continue to benefit all the ongoing government-related projects as it will partially cover increases in materials costs until projects' completion.
- **Introduction of multi-tiered levy on foreign workers.** We believe the labour shortage issue will take a longer time to be resolved due to the lengthy processes and competition with other sectors to secure the incoming workers. To put further pressure to the situation, a multi-tiered levy for foreign workers is expected to commence in 2023. This will further increase the cost for construction players as the sector is among the ones that recruit a large number of foreign workers. While this may motivate contractors to adopt Industrialised Building System (IBS) in their projects, we believe the transition will take time and the sector will continue to rely on foreign workers in the near future. Those who already utilise IBS, such as Gamuda and IJM, will stand ahead of their peers in this aspect.
- **Gamuda's highway disposal near completion.** RM5.5b Sukuk was successfully raised by ALR on 23 Sep 22 despite the volatile market. The drawdown and final completion are expected by mid-October with cash proceeds expected to be received in the next few months. 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 disposal will help to deleverage its balance sheet (change to net cash position of >RM1b) and can be used to fund future projects.

CONSTRUCTION INDEX OUTPERFORMED THE FBMKLCI

End Dec 21=100



Source: Bloomberg, UOB Kay Hian

MEGA PROJECTS PIPELINE

Project	Value (RMb)	Remarks
ECRL	50	Status: Over 30% completion as of Sep 22. Target to achieve 37% progress in 2022 with expected completion in Dec 26. Potential beneficiaries: UM Corp (for vertical package); Eonpile, 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, YTL, HSS.
Pan Borneo Highway Sabah	4	Status: Cabinet approval on 4 March to proceed with the remaining 19 work packages (five years). Phase 1 65% done. Potential beneficiaries: Suria Capital (JV with GAQRS), WCT
Rapid Transit System (RTS)	4	Status: Reached over 20% progress as of Sep 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: Various, 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: Various, UOB Kay Hian

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