CLSA

SunCon

RM2.32 - BUY

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25 August 2017

Malaysia
Infrastructure

Reuters	SCOG.KL
Bloomberg	SCGB MK

Priced on 24 August 2017
KLSE Comp @ 1,775.5

12M hi/lo RM2.36/1.59

12M price target RM2.75
±% potential +19%

Shares in issue 1,292.9m
Free float (est.) 45.6%

Market cap US$701m

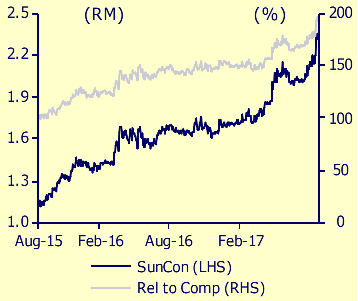
3M average daily volume
RM3.0m (US$0.7m)

Foreign s'holding 9.0%

Major shareholders
Sunway Berhad 54.4%
Sungei Way Corp Sdn Bhd 10.1%

Stock performance (%)

	1M	3M	12M
Absolute	12.6	12.1	41.5
Relative	11.8	11.8	34.0
Abs (US$)	12.7	12.4	33.1



Source: Bloomberg

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Still a shining star

Change in earnings

Construction segment's best pre-tax profit since listing

Faster QoQ job progress and better margins propelled this pure-play contractor to its best quarterly showing for its construction segment since listing, and a 18% YoY earnings improvement for SunCon overall in 1H17. However, SunCon's earnings for 1H17 formed only 42%/46% of ours/street's full-year estimates as its pre-cast segment was weighed down by slower progress by its customers (main contractors); this we think would be a near-term irritation. Still, margins that have been better than expected, leading us to upgrade earnings by 7%/8% for 18CL/19CL. Reiterate BUY with a higher TP of RM2.75 (was RM2.55).

Best construction quarter since listing; RM1bn of jobs secured

The RM1bn of jobs secured YTD (51% in-house, 49% external) has met 45% of our RM2.2bn replenishment target. With a RM14bn tender book, for its near-term pipeline, we fancy SunCon's chances to be among winners for the RM9bn Light Rail Transit 3, where it has submitted a few bids and boasts a good track record (bagged RM3.4bn of rail jobs in 6 years). Meanwhile, no shortage of in-house prospects - its parent is adding five hospitals over the next 2-3 years which should keep such work flowing in.

Delayed gratification in pre-cast as revenue recognition slowed

Pre-tax profit for pre-cast segment came in only at RM6m in 2Q17 - low versus historical norms - despite slightly enlarged order book (at RM251m). While results for 17CL will be dampened, we expect the fulfilling of the backlog to create a slight bumper effect in 2018. On balance, pre-tax profit margin in this division still stayed robust at 22% for 1H17.

Enhanced margins and cashflow

Stripping out arbitration gains, SunCon's pre-tax profit margin still came in at 9.7% for 1H17 (above our estimate of 8.4% for 2017). SunCon's operating cashflow improved in 1H17, augmenting its net cash pile, which also saw the declaration of an interim dividend equivalent to 54% of profits for 1H17.

Upgraded TP; earnings delivery supports price gains

Given the slow revenues for its pre-cast division, we lower our earnings for 17CL, but steadily improving construction margins on existing jobs lead us to nudge up earnings for 2018 and 2019. Our revised TP of RM2.75 is arrived at with an unchanged multiple of 16.7x PE on 18CL earnings, ie, at 1 sd above 3-year sector average.

Financials

Year to 31 December	15A	16A	17CL	18CL	19CL
Revenue (RMm)	1,917	1,789	2,321	2,839	2,897
Rev forecast change (%)	*-*	*-*	*(7.7)*	*(3.0)*	*(8.1)*
Net profit (RMm)	127	124	157	210	222
NP forecast change (%)	*-*	*-*	*(7.1)*	*7.6*	*8.4*
EPS (sen)	9.8	9.6	12.1	16.3	17.2
CL/consensus (12) (EPS%)	-	-	101	125	128
EPS growth (% YoY)	39.4	(2.9)	27.0	34.1	5.7
PE (x)	23.6	24.3	19.1	14.2	13.5
Dividend yield (%)	1.7	2.2	3.2	3.7	3.9
ROE (%)	30.6	26.2	30.0	34.9	31.5
Net debt/equity (%)	(56.2)	(66.7)	(66.1)	(70.3)	(69.6)

Source: CLSA

For important disclosures please refer to page 7.

Figure 1

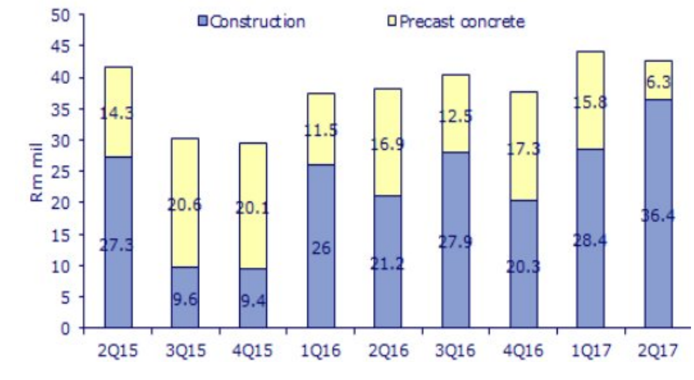
SunCon: Financials

FYE 31 Dec (RM m)	1H17	1H16	YoY % Chg	2Q17	1Q17	QoQ % Chg	Remarks
Revenue	836.8	854.6	(2%)	417.2	419.5	(1%)	Pre-cast concrete segment revenues dipped 56% QoQ in 2Q17
Operating expenses	(760.6)	(801.1)	(5%)	(380.5)	(380.1)	0%	
Other income	5.5	4.7	16%	5.0	2.6	91%	
Ebitda	**102.1**	**92.5**	**10%**	**50.9**	**51.2**	**(1%)**	Higher margins led to a 10% increase in Ebitda YoY despite lower revenues
Depreciation	(18.3)	(19.5)	(6%)	(9.1)	(9.1)	0%	
Ebit	**83.8**	**73.0**	**15%**	**41.7**	**42.1**	**(1%)**	
Interest income	5.5	4.7	16%	2.3	3.2	(28%)	
Interest expense	(2.3)	(2.1)	12%	(1.3)	(1.1)	18%	Given its net cash position, SunCon pays very minimal interest
Pre-tax profit	**86.9**	**75.6**	**15%**	**42.8**	**44.2**	**(3%)**	For 1HFY17, pre-tax profit would have increased 7% if an arbitration gain in 1H17 of RM6 million was excluded
Tax	(15.6)	(15.3)	2%	(6.1)	(9.5)	(36%)	
Effective tax rate	17.9%	20.2%	(11%)	14.2%	21.6%		
Minority interest	0.1	0.0		0.1	0.0		
Net profit	**71.4**	**60.3**	**18%**	**36.8**	**34.7**	**6%**	
EPS (sen)	5.52	4.67	18%	2.84	2.68	6%	
EBIT margin	*10.0%*	*8.5%*		*10.0%*	*10.0%*		
PBT margin	*10.4%*	*8.8%*		*10.3%*	*10.5%*		For 2 consecutive quarters, pre-tax profit margin hovered at around 10.5%

Source: CLSA, Company

Figure 2

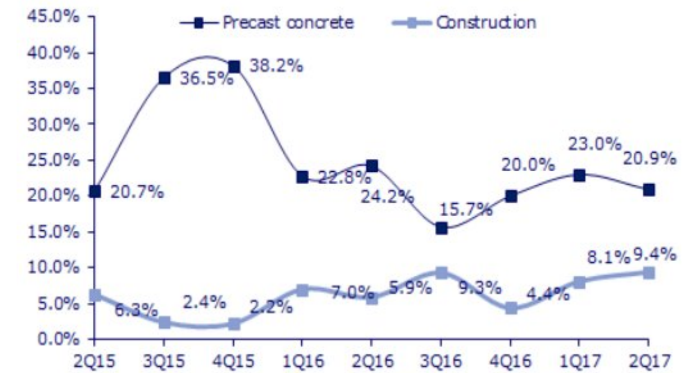
Pre-tax profit for construction and pre-cast concrete division – Construction picking up the slack



Source: CLSA, Company

Figure 3

Pre-tax margins for construction continued to rise while that for pre-cast concrete maintained above 20%



Source: CLSA, Company

Rising construction earnings and margin; best quarter since listing

Sunway's construction division delivered RM36.4m of pre-tax profits, its best showing with margins widening to 9.4% (inclusive arbitration gains), and is on a rising trend (see Figure 3). We believe this indicates that its key jobs are progressing well. Based on outstanding value of key large jobs, the Klang Valley Mass Rapid Transit Line 2 package V201 and Putrajaya Parcel F (that form close to half its order book) are only 20% and 34% complete respectively, suggesting good margins are likely to stay. That the major holidays (Chinese New Year and Eid) took place in 1H17 also suggests higher tendency for more work progress in 2H17.

Figure 4

SunCon's key outstanding jobs

RM million	Contract sum	Outstanding Value	% Complete	Completion
Putrajaya Parcel F	1,610	1,064	34%	3Q2018
MRT V201	1,213	974	20%	2Q2021
Sunway Serene - Serviced Residences	449	449	0%	4Q2020
Suway Medical Center 4	428	394	8%	4Q2018
International School of Kuala Lumpur	268	202	25%	2Q2018
KLCC (NEC + Package 2 & 2a)	646	170	74%	4Q2018
Gas district cooling	152	148	3%	3Q2018
Other construction work		626		
Pre-cast		**251**		
Total		**4,278**		

Source: CLSA, Company

Prospects abound – externally and in-house

Parent's healthcare wave a promising prospect

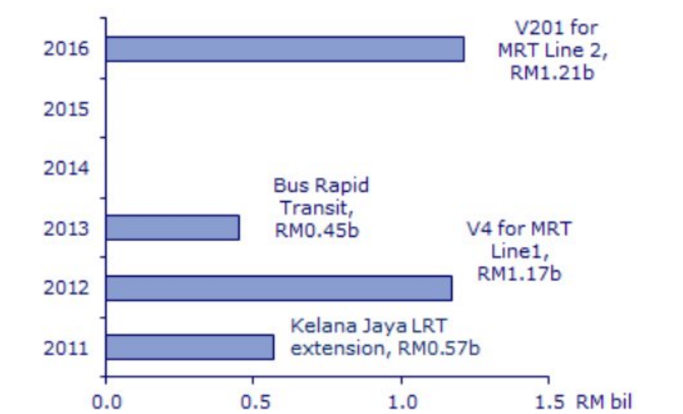
SunCon's parent, Sunway Berhad, has announced its intention to expand to hospitals to Penang (2 hospitals), Damansara, Johor and Ipoh. Having been involved in both Sunway Berhad's hospitals so far – in Cheras and in Bandar Sunway – we think SunCon has an upper hand in securing such rollouts. Total value that Sunway Berhad would be investing is RM1bn, of which a majority portion would likely be construction costs.

Several bids for LRT 3

According to Sunway, it has put in several bids for the LRT 3 project, including for the longest sections, which should increase its chances of bagging at least one of the infrastructure parcels. It has strong credentials in rail related work to back, where over the past six years, SunCon has clinched a total of RM3.4bn of such jobs.

Figure 5

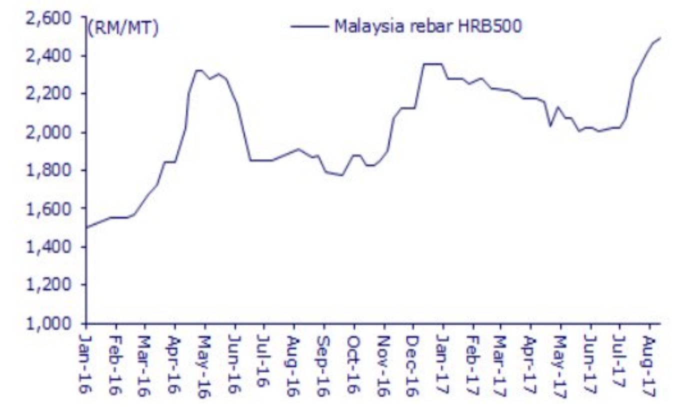
Rail related jobs in past years for SunCon



Source: CLSA, Company

Figure 6

Steel price movements



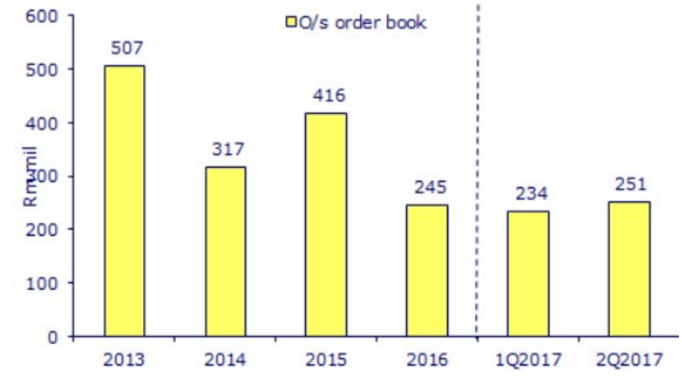
Source: CLSA, Company

Rising steel prices but key jobs have some insulation

Steel prices which have jumped recently may adversely impact construction players. We highlight that 29% of its outstanding order book is insulated from such price volatilities given pass-through clauses for the Mass Rapid Transit Line 2 project (22%) and its Singapore pre-cast business (7%). Further, in another large job, Putrajaya Parcel F (25% of outstanding order book), a portion of steel requirements were procured earlier (job was secured in late 2015) which provides margin buffer to the project. As a practise, we understand that SunCon typically locks in future steel requirements for the next 6 months.

Figure 7

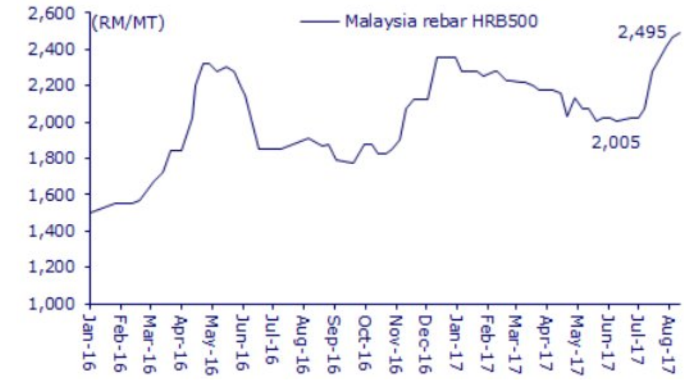
Pre-cast order book – mild increase



Source: CLSA, Company

Figure 8

Steel prices trend show quick increase recently



Source: CLSA

We think pre-cast segment will play catch up

Slow progress by main contractor impeded pre-cast work

Slow progress by main contractor in building Singapore's Housing Development Board flat units caused a slowdown in delivery and revenue recognition for SunCon. We think that with the fulfilling of orders will occur in the future and have a small bumper effect on earnings YoY for 18CL. Nevertheless we observe that margins stay solid at 20% for 2Q17 in this segment helped by closure of Tampines plant in Singapore and now operating out of Senai and Iskandar in Johor (with a total capacity of 156,600m3).

Overall demand resilient

Overall demand for SunCon's pre-cast products is largely dictated by Singapore's Housing and Development Board (HBD) which we view to be resilient. Having launched 12,755 units of build-to-order flat units up to early August and with an upcoming exercise to offer another 4,800 units in November, total supplied units by HDB are likely to closely match the 17,891 units seen in 2016.

Reiterate BUY; raise TP

Still valuing SunCon at +1sd above 3-year mean sector PB

We continue to like SunCon as a pure-play contractor with prospects of padding up jobs from both in-house and external sources; in house-jobs currently form 31% of total order book. It also has the safety of a strong cashflow generation against a low debt, which warrants a premium to sector average valuation in our view. We value SunCon at 16.7x PE, which is equivalent to 1sd above sector 3-year mean PE.

Earnings revised lower for 17CL

As profit margins on existing jobs have exceeded our estimates, we revise upwards the expectation of profit margins of existing large jobs and contracts to be secured. At the same time, we lower the expected revenue and earnings for 2017 to reflect slow progress in pre-cast deliveries which we believe will play catch up.

SunCon is trading at 15.8 times forward PE, which we believe is supported by its strong prospects and earnings growth

Figure 9

Summary of changes

		17CL	18CL	19CL
Pre-tax profit margins (%)	Previous	8.4%	8.4%	8.4%
	Revised	8.5%	9.3%	9.5%
Net profit (RM mn)	Previous	169	196	205
	Revised	157	210	222

Source: CLSA

Figure 10

SunCon's forward PE

Source: CLSA

Valuation details

We value SunCon using the price-earnings multiple approach. Its target price is derived from 16.7x 18CL earnings, which is based on 1sd above the 3-year construction sector mean forward PE ratio; this is still below the same ratio for heavyweights Gamuda and IJM, but above its mid-cap peers. We accord premium valuations over mean in our calculations to reflects its robust ROEs of more than 20%, strong cashflow generation backed by steady job orders from both internal and external sources. We further note that in our valuations, we have not incorporated benefit from its consistent net cash position.

Investment risks

The investment risks for SunCon mainly stem from construction risk. Specific risk to our estimates would be lower-than-expected margins (below 5-8%) or amount of projects secured falls below our expectation, either due to inability to secure projects or caused by delay on project roll-out. The increase in steel prices beyond anticipated will also creep into margins as SunCon hedges steel needs for a future 6-month period. On the pre-cast segment, risks to our earnings will be erosion of its currently-strong margins of 20% and/or the inability to retain customers due to the shift in its plant location (from Singapore to Malaysia) causing a slowdown in orders.SunCon is also susceptible to risk facing the construction industry in general, which includes the risk of disputes and ensuing lengthy negotiations which is not uncommon, not to mention the fluctuations in raw materials and availability of labour.

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The Global Equities Database

Summary financials

Year to 31 December	2015A	2016A	2017CL	2018CL	2019CL
Summary P&L forecast (RMm)					
Revenue	**1,917**	**1,789**	**2,321**	**2,839**	**2,897**
Op Ebitda	178	188	246	317	334
Op Ebit	136	149	190	256	269
Interest income	8	10	12	13	15
Interest expense	(4)	(6)	(5)	(5)	(5)
Other items	-	0	-	-	-
Profit before tax	**141**	**154**	**196**	**263**	**278**
Taxation	(13)	(30)	(39)	(53)	(56)
Minorities/Pref divs	(1)	0	0	0	0
Net profit	**127**	**124**	**157**	**210**	**222**
Summary cashflow forecast (RMm)					
Operating profit	**136**	**149**	**190**	**256**	**269**
Operating adjustments	(3)	(22)	0	0	0
Depreciation/amortisation	42	39	57	61	66
Working capital changes	65	(59)	(49)	(38)	(72)
Net interest/taxes/other	(8)	(33)	(39)	(53)	(56)
Net operating cashflow	**232**	**75**	**158**	**227**	**207**
Capital expenditure	(39)	(19)	(30)	(30)	(30)
Free cashflow	**193**	**56**	**128**	**197**	**177**
Acq/inv/disposals	40	13	-	-	-
Int, invt & associate div	(57)	89	12	13	15
Net investing cashflow	**(56)**	**83**	**(18)**	**(17)**	**(15)**
Increase in loans	2	0	-	-	-
Dividends	(70)	(84)	(97)	(110)	(116)
Net equity raised/other	0	-	0	0	0
Net financing cashflow	**(68)**	**(84)**	**(97)**	**(110)**	**(116)**
Incr/(decr) in net cash	**107**	**74**	**43**	**99**	**75**
Exch rate movements	5	2	(5)	(6)	(5)
Opening cash	**278**	**390**	**465**	**503**	**597**
Closing cash	**390**	**465**	**503**	**596**	**667**
Summary balance sheet forecast (RMm)					
Cash & equivalents	390	466	503	597	666
Debtors	579	732	776	949	968
Inventories	17	24	0	0	0
Other current assets	230	220	233	233	233
Fixed assets	162	138	112	81	45
Intangible assets	4	6	6	6	6
Other term assets	14	11	11	11	11
Total assets	**1,397**	**1,597**	**1,640**	**1,877**	**1,930**
Short-term debt	137	137	137	137	137
Creditors	796	955	949	1,085	1,032
Other current liabs	9	11	-	0	-
Long-term debt/CBs	-	-	-	-	-
Provisions/other LT liabs	4	1	1	1	1
Minorities/other equity	1	1	1	1	1
Shareholder funds	451	493	553	654	760
Total liabs & equity	**1,397**	**1,597**	**1,640**	**1,877**	**1,930**
Ratio analysis					
Revenue growth (% YoY)	1.9	(6.7)	29.8	22.3	2.0
Ebitda growth (% YoY)	10.2	5.7	30.8	28.8	5.4
Ebitda margin (%)	9.3	10.5	10.6	11.2	11.5
Net profit margin (%)	6.6	6.9	6.8	7.4	7.7
Dividend payout (%)	40.6	52.3	61.8	52.2	52.3
Effective tax rate (%)	9.2	19.5	20.0	20.0	20.0
Ebitda/net int exp (x)	-	-	-	-	-
Net debt/equity (%)	(56.2)	(66.7)	(66.1)	(70.3)	(69.6)
ROE (%)	30.6	26.2	30.0	34.9	31.5
ROIC (%)	59.1	65.5	86.0	107.0	100.9
EVA®/IC (%)	48.2	54.6	75.1	96.1	90.0

Source: CLSA

Companies mentioned

SunCon (SCGB MK - RM2.32 - BUY)
Sunway (N-R)

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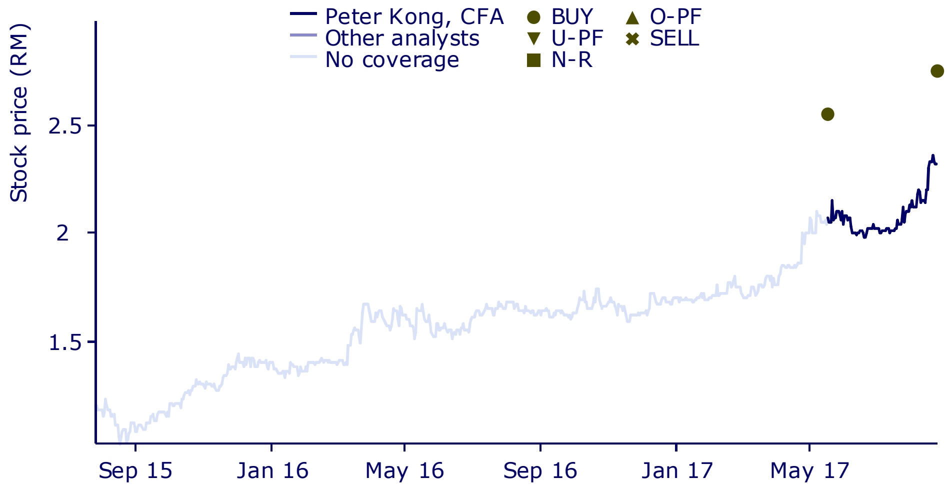

Date	Rec	Target	Date	Rec	Target
LATEST	BUY	2.75	18 May 2017	BUY	2.55

Source: CLSA

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We define as "Double Baggers" stocks we expect to yield 100% or more (including dividends) within three years at the time the stocks are introduced to our "Double Bagger" list. "High Conviction" Ideas are not necessarily stocks with the most upside/downside, but those where the Research Head/Strategist believes there is the highest likelihood of positive/negative returns. The list for each market is monitored weekly.

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