Construction firms seen eyeing potential infrastructure projects

Construction sector

Maintain neutral: Will the performance of construction stocks on Bursa Malaysia in 2020 mirror that of last year? In 2019, share prices of construction companies made a significant rebound from their oversold positions as investors turned positive on hopes that the worst was already over for the sector. The Bursa Malaysia Construction Index jumped 35.6% (until Dec 20, 2019) with most of the gains posted in the first half of 2019. The strong performance was led by big capitalisation (cap) contractors, namely Gamuda Bhd (+68.4% year to date [YTD]), Sunway Construction Group Bhd (+42.1% YTD) and IJM Corp Bhd (+36.4% YTD). For 2020, as expectations are building up for the government to stimulate the economy by rolling out major infrastructure projects, investors will be hoping the excitement will eventually translate into positive share price reactions on our local bourse.

To put things in perspective, most construction stocks are now trading at elevated valuations following the sector's strong performance last year. Reflecting this, the Bursa Malaysia Construction Index is now trading at a forward price-earnings ratio (PER) of 13.5 times, or one standard deviation (1 SD) above its historical mean. Investors are essentially holding out for further positive developments to take the construction shares to higher levels.

For the construction stocks to climb further, investors will be watching out for earnings catalysts from new contract wins. In particular, the companies will be eyeing to replenish their order books from the slew of potential infrastructure projects in the pipeline.

A closer look at the list of potential major infrastructure projects reveals that the timing of commencement for most of them will likely lean towards the second half of 2020. This includes the possible revival of the Kuala Lumpur-Singapore High Speed Rail project — with a decision due to be made by May 2020 — and Mass Rapid Transit 3, possibly towards year end as the government may want to space out the infrastructure spending spree due to its tight fiscal constraints. While there may be initial knee-jerk share price movements in response to any news flows on the relaunching of these megaprojects, given the typical time lag before the actual construction packages are awarded on an open tender basis, it will be a guessing game initially to identify the potential beneficiaries with any meaningful earnings impact expected to be felt starting from two to three years later.

Nonetheless, one major project that is slated to kick off as early as January this year is the Penang Transport Master Plan (PTMP). The signing of the agreement between the Penang state government and SRS Consortium is scheduled to take place soon under a project delivery partner structure. PTMP consists of three key components — the RM8.4b Light Rail Transit (LRT) project, the RM7.5b Pan Island Link highway and the RM16 billion reclamation of three south islands, with physical works likely to start in the second half of 2020. This is expected to benefit Gamuda, which has a 60% interest in SRS Consortium.

The open tender model and stiff competition for construction jobs will also put pressure on construction margins. Coupled with the slow pace of construction progress so far for key projects such as LRT3 and East Coast Rail Link that had already been revived previously, this has taken a toll on the performance of construction companies. While it may take time for contractors along the value chain to replenish their order books, they will be relying on existing order books to sustain their earnings in the near term.

On the back of expectation of the government to implement more infrastructure projects to create the multiplier effects in the economy, there will be sustained investor interest to support the share prices of construction companies.

We prefer Gamuda (for big-cap exposure) which offers near-term visibility on order-book replenishments as it is on the verge of clinching the multi-year PTMP. While our existing call is "market perform" with a target price (TP) of RM3.90, there is potential to upgrade our recommendation/TP on the back of the signing of the PTMP agreement as soon as January 2020. Our on-the-back-of-the-envelope calculation suggests that Gamuda may potentially rake in a share of profit of RM65 million in the first year based on preliminary assumptions, which could translate into an incremental value of 42 sen per share after applying a PER of 16.1 times. We also prefer Kimlun Corp Bhd ("outperform" with TP of RM1.65 based on PER of 8.6 times or 1SD above historical mean) as a small-cap contractor play with exposure to the affordable housing segment and increased infrastructure job opportunities in Singapore.

Our major concerns about the sector are: i) margin compression arising from intense competition (including from foreign peers) and rising operating expenses from higher labour and raw material costs; ii) slower-than-expected order book replenishment as fewer construction jobs are available; iii) execution risks due to slow pace of contract renegotiations; and iv) impairment of receivables. — *Kenanga Research, Jan 3*