Government restriction concerns

Sector Update

Construction

UNDERWEIGHT (maintain)

Construction activities have been brought nearly to a standstill for a month since 18 March 2020 due to the government's Movement Control Order (MCO). The MCO has been extended to 28 April 2020 but some approved projects will be allowed to resume on a case-by-case basis. There is earnings forecasts risks in 2020E if the MCO is prolonged. However, sector net gearing is below historical average, while interest coverage and quick ratios are at comfortable levels. We remain UNDERWEIGHT the Construction Sector. Top BUYs are SunCon, AME and Taliworks. Top SELLs are Gamuda, IJM Corp and MRCB.

Uncertainties remain on resumption of work

Most listed contractors have applied to resume works on their construction projects. But we gather that the companies under our coverage have not received the government's decision on the resumption of works. This is despite the extended MCO period starting on 15 April 2020 and ending on 28 April 2020. There is a risk that the MCO period could be extended further if the cases of Covid-19 infection remains high. Hence, the contractors continue to pursue the approval to resume works to reduce the risk of delays in the completion of projects.

Negative impact of MCO

The MCO will impact construction and property development progress billings, traffic volume for toll highway concessions and property sales as show galleries are closed. Even when the MCO is lifted we expect a slow recovery as strict work and travel restrictions will likely remain, to prevent Covid-19 infection. We have assumed aggregate revenue for our universe of construction companies to contract 4% yoy in 2020E and 5% yoy in 2021E (-10% yoy in 2019). As a result, we expect sector core net profit to contract 9% yoy in 2020E and 1% yoy in 2021E (-25% in 2019).

Some infrastructure projects are likely to resume works

We believe the Klang Valley MRT Line 2 (MRT2), LRT Line 3 (LRT3), East Coast Rail Link (ECRL) and Pan Borneo Highway (PBH) projects will likely be allowed to resume. These projects have Centralised Labour Quarters (CLQ) near the project sites and construction works along the road or railway alignments will generally mean most workers practice social distancing. The resumption of these projects will benefit the contractors involved, which includes **Gabungan AQRS**, **Gamuda**, **HSS Engineers**, **IJM Corp**, **MMC Corp**, **MRCB**, **Sunway Construction (SunCon)** and **WCT**. However, the government will likely impose limits on the number of workers at each site and working hours to reduce Covid-19 infection risk. Hence, work progress may not resume at full capacity compared to before the virus outbreak.

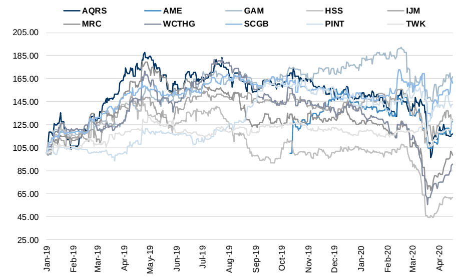
Good financial position to weather downturn

We believe the construction companies are in a better financial position to weather the current cyclical downturn compared to the Asian Financial Crisis (AFC) and Global Financial Crisis (GFC) periods. Based on Bloomberg data, we estimate aggregate construction sector net gearing was 0.59x in 2019, higher than 0.52x in 2008 (GFC) but lower than 1.26x in 1997 (AFC) levels. Sector interest cover was a comfortable 4.2x in 2019, the same level as 2008 but higher than 2.8x in 1997. Quick ratio was at a comfortable 1.1x in 2019, higher than 1.0x in 2008 and 0.7x in 1997. We remain cautious on the sector given the weak earnings visibility due to the MCO impact and order book replenishment concerns. Maintain our **UNDERWEIGHT** call on the sector.

Absolute Performance (%)

	1M	3M	12M
AME	23.8	-19.3	NA
AQRS	-4.1	-30.9	-41.4
Gamuda	20.0	-21.0	5.2
HSS Eng	49.2	-46.3	-58.9
IJM Corp	25.0	-20.8	-21.2
MRCB	42.3	-30.8	-45.7
Pintaras	7.7	-11.7	11.3
SunCon	21.9	-2.7	-9.2
WCT	58.7	-39.0	-45.5
Taliworks	26.1	-2.9	-8.2

Relative Performance to KLCI (%)



Source: Affin Hwang, Bloomberg

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Movement control order extended

The Prime Minister Tan Sri Muhyiddin Yasin announced on 10 April 2020 that the MCO has been extended to 28 April 2020. The government will allow an additional list of businesses to operate during the MCO, but the health and safety of workers remains a top priority, says International Trade and Industry Minister Datuk Seri Azmin Ali.

Certain businesses and construction projects allowed to operate

Azmin said industries allowed to operate during MCO are automotive, machineries and equipment, aerospace and construction projects. The construction projects and services related to construction works allowed to operate under MCO are:

- Projects whereby the main contractors are G1–G2;
- Projects that have achieved physical progress of 90% and above;
- Tunnelling works;
- Maintenance works;
- Sloping works;
- Emergency works that are consequent to contractual obligations;
- Maintenance, cleaning and drying of stagnant water, spraying of pesticides at construction sites which prevent the breeding of Aedes mosquitoes and other pests;
- Other works that if left incomplete may result in danger;
- Building projects with 70 IBS score and above;
- Construction projects with accommodation facilities for workers, such as centralised quarters for workers or workers' camp; and
- Professional services related to the construction industry including architects, engineers, town-planners, land surveyors, quantity surveyors, project managers, facility managers as well as other relevant services.

Pending approval to resume construction works

We understand that the construction companies are applying to the government to resume works on their construction projects. We believe infrastructure projects highlighted by the government in the economic stimulus plan such as ECRL, MRT2 and National Fiberisation and Connectivity Plan will be allowed to resume works. We believe other essential infrastructure projects that could be allowed to resume works are the LRT3, PBH and West Coast Expressway (WCE). We gather that an important criteria for projects to resume works is to have CLQs near the construction site to house workers and these projects have such facilities.

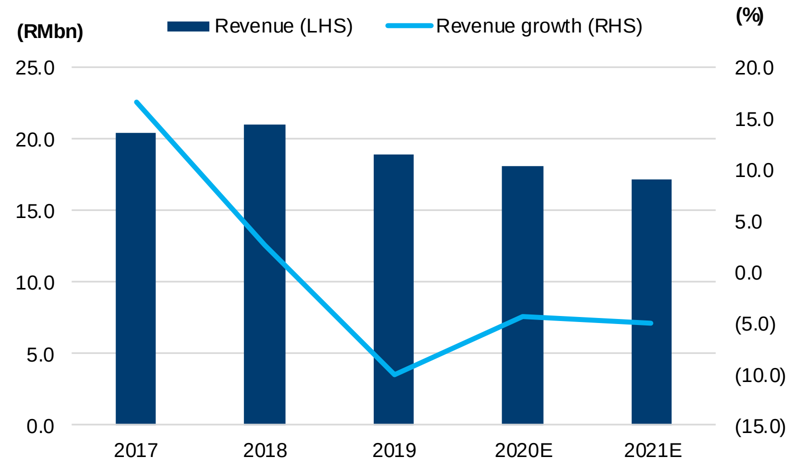
Critical works are allowed to continue

Some contractors have received the government's approval to undertake critical works to ensure construction site safety. MMC Gamuda Joint Venture has continued the MRT2 tunneling works during the MCO period as stopping works will pose a danger of the tunnel collapsing. WCT has been undertaking critical works for MRT2 above-ground works and PBH since late-March 2020. Other building projects with high Industrial Building System (IBS) content (at least 70% of materials used) and near completion (at least 90% complete) may also resume works subject to the approval of the authorities.

Certain contractors to benefit

We believe the resumption of major infrastructure projects will benefit the contractors involved as progress billings can resume as construction works continue. Contractors under our coverage involved in the (1) MRT2 project includes HSS, IJM Corp, SunCon, WCT and MRCB; (2) LRT3 project includes AQRS, SunCon and WCT; (3) PBH project includes HSS, Gamuda and WCT; and (4) WCE project includes HSS, IJM and WCT.

Fig 1: Aggregate construction sector revenue and yoy change



Source: Affin Hwang, company

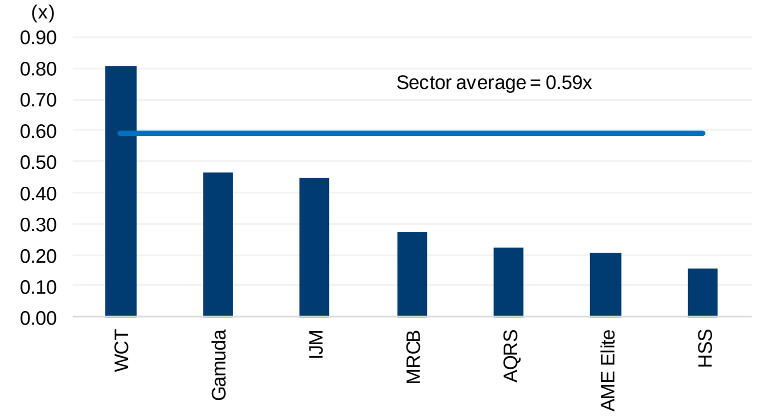
Strong financial position and high profit margin for resilience

Given the low or absence of revenue while incurring fixed costs during the MCO period, strong financial position and the ability to meet short-term liabilities are critical to ensure the sustainability of operations. We understand that large contractors generally have a flexible cost structure, ie, fixed costs usually comprise about 15-20% of total costs. They generally outsource most of their semi-skilled and low-skilled labour requirements to subcontractors. We believe construction companies with low net gearing, high quick ratio and high EBITDA margins will be more resilient to weather the current cyclical downturn.

AME, Pintaras, SunCon and Taliworks are relatively more resilient

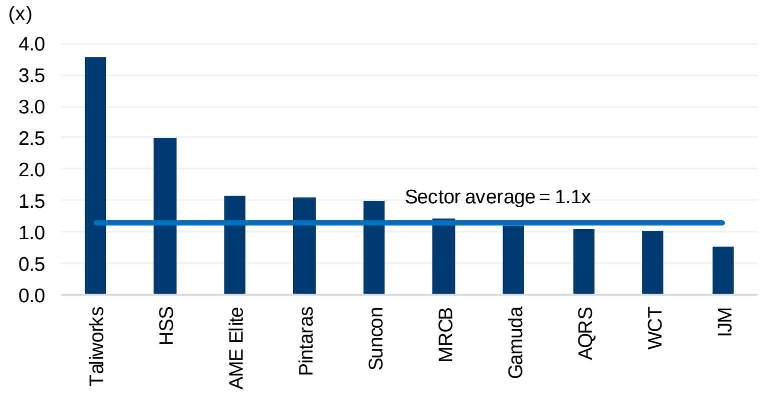
AME, **HSS**, **Pintaras**, **SunCon** and **Taliworks** stand out in the sector with net cash positions (low net gearing for AME and HSS) and relatively high quick ratios. AME, Pintaras and Taliworks also have relatively high EBITDA margins that provide a buffer to absorb costs even with lower revenue before incurring any cash losses. High EBITDA generation indicates high cash profits to sustain operations during periods of tight liquidity such as the current MCO period.

Fig 2: Construction companies' net gearing



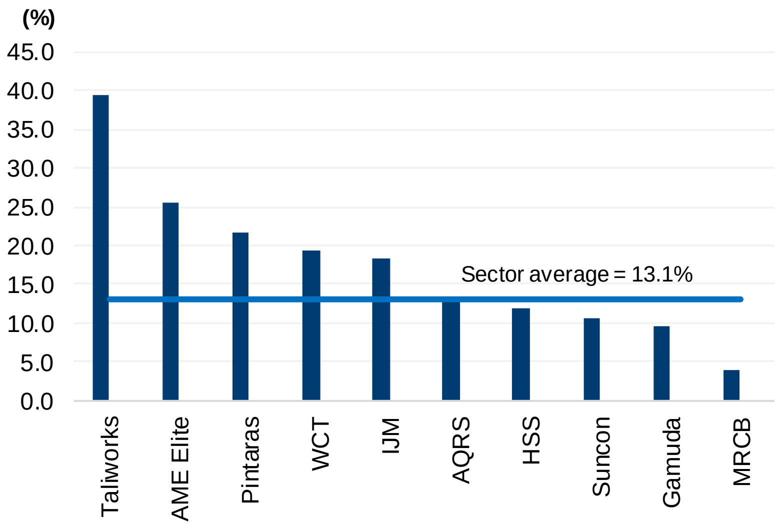
Source: Affin Hwang, company

Fig 3: Construction companies' quick ratio



**Cash ratio = Cash/Current liabilities, Quick ratio = (Current assets – Inventories)/Current liabilities,*
Source: Affin Hwang, company

Fig 4: Construction companies' EBITDA margin

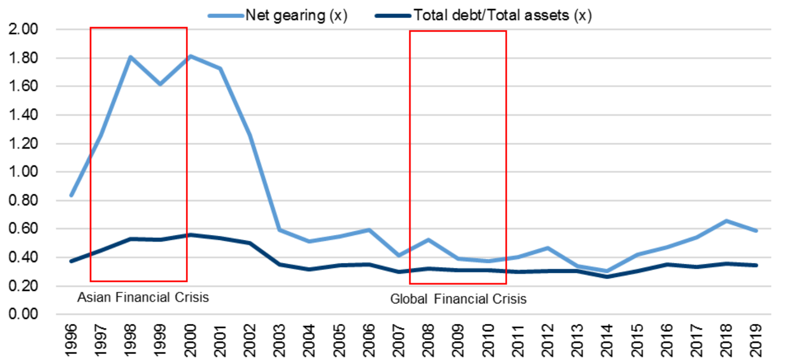


Source: Affin Hwang, company

Manageable gearing level

Aggregate construction net gearing has been rising over the last 5 years due to the implementation of large-scale infrastructure projects such as the MRT2, LRT3, PBH, WCE, Gemas-Johor Bahru Double Tracking and several toll highway projects. At 0.59x, we believe the sector net gearing is at a manageable level and does not post a systemic risk to the banks. We understand that most of the debt comprise of Ringgit-denominated long-term bonds and bank borrowings (working capital and term loans). This reduces forex risk of the current weak Ringgit, given the construction sector's relatively low exposure to US$-denominated debt compared to during the AFC in 1997. Total debt/total assets was at 0.35x, compared to 0.32x in 2008 and 0.45x in 1997.

Fig 5: Aggregate construction sector net gearing and total debt ratios

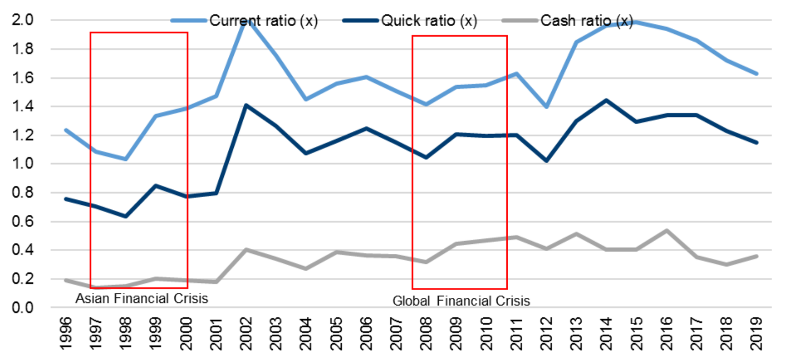


** Aggregate figures of KL Construction Index component stocks and de-listed Renong and Sunway Holdings*
Source: Affin Hwang, Bloomberg

Manageable short-term financial positions

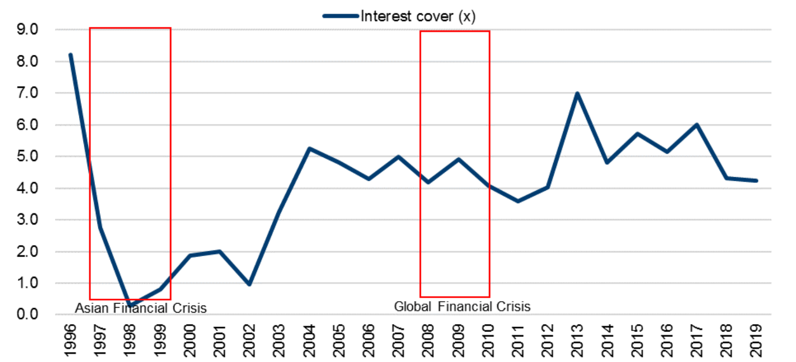
We examine the construction sectors short-term financial position by looking at the balance sheet cash ratio, quick ratio and current ratio. Quick ratio of 1.1x in 2019 (generally at least 1x is a comfortable level) indicates that most construction companies have sufficient liquid assets to meet current liabilities. Current ratio of 1.6x in 2019 also indicates most construction companies have surpluses of current assets after meeting their current liabilities. High interest cover of 4.2x in 2019 highlights the sector generates more than sufficient earnings to service interest expense.

Fig 6: Aggregate construction sector cash, quick and current ratios



**Cash ratio = Cash/Current liabilities, Quick ratio = (Current assets – Inventories)/Current liabilities, Current ratio = Current assets/Current liabilities*
Source: Affin Hwang, Bloomberg

Fig 7: Aggregate construction sector interest cover ratio

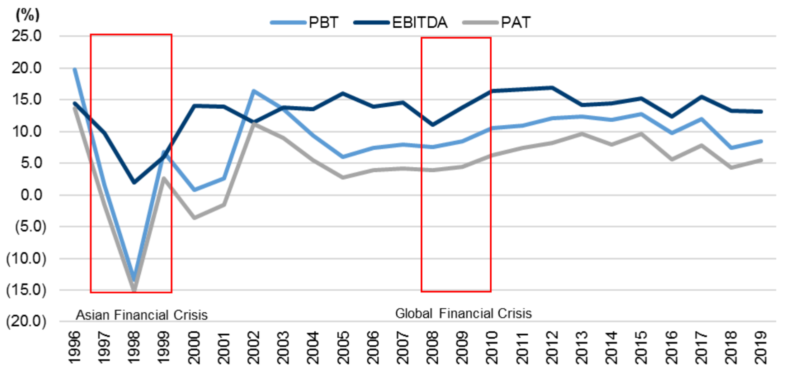


**Interest cover = EBITDA/Interest expense*
Source: Affin Hwang, Bloomberg

Sustained EBITDA margins

Construction sector average profit margins have been easing over the past 2 years due to challenging market conditions. But EBITDA margins remain relatively stable over the past 10 years with average of 14.8%. Hence, the cash profit generation for the construction companies have been good. The sharp decline in EBITDA margins was seen in 1998 at the peak of AFC. We believe the risk of severe EBITDA margin erosion in 2020 similar to the AFC is low as we do not expect a severe and prolonged disruption in the construction sector. Profit margins of the large construction companies under our coverage are also relatively more resilient as they are well managed and have not been too aggressive in pricing tenders to win contracts in recent years.

Fig 8: Aggregate construction sector profit margins



**EBITDA margin = EBITDA/Revenue, PBT margin = PBT/Revenue, PAT margin = PAT/Revenue*
Source: Affin Hwang, Bloomberg

Government focus on helping people and small businesses

The new government has its hands full in trying to contain the virus outbreak. The RM260bn economic stimulus plan announced by the government focuses on supporting the people and small businesses affected by the MCO and economic downturn. Only RM2bn was allocated to construction spending on small projects benefiting mostly small unlisted contractors. There is less focus on the revival of large-scale infrastructure projects.

Government budget constraint in infrastructure spending

Lower government revenue due to low oil price and lower direct tax collections coupled with higher operating expenditure will increase the federal government deficit to 4.9% of GDP in 2020E from 3.2% previously, based on the forecasts provided by the Ministry of Finance. The budget constraint will likely limit the government's ability to increase infrastructure spending to pump-prime the economy unless the government raises more debt or government-guaranteed bonds. Hence, we believe the implementation of infrastructure projects such as the MRT3 and KL-Singapore High Speed Rail will likely be deferred.

Remain UNDERWEIGHT the Construction Sector

We believe this will dampen sentiment on the construction sector due to order book replenishment concerns and poor earnings visibility due to the MCO. But we believe the construction companies have relatively strong balance sheets to weather the current downturn. Given the uncertainties on earnings prospect, we remain UNDERWEIGHT the sector. Top sector BUYs are **SunCon**, **AME** and **Taliworks**. Top SELLs are **Gamuda**, **IJM Corp** and **MRCB**.

Fig 9: Construction peer comparison

Company Name	Rating	Share Pr	TP	Mkt Cap	Year End	Core PE (x)		Core EPS growth (%)		EV/EBITDA (x)		BV/sh (RM)	P/BV (x)	ROE (%)	Div Yield (%)		RNAV/	Sh Pr discount
		(RM)	(RM)	(RMb)		CY20E	CY21E	CY20E	CY21E	CY20E	CY21E	CY20E	CY20E	CY20E	CFY20E	CFY21E	share	to RNAV
IJM CORP	SELL	1.75	1.24	6.4	Mar	31.2	30.0	(27.1)	4.2	11.6	11.7	3.0	0.6	1.8	1.7	1.7	2.06	15.0
GAMUDA	SELL	3.24	2.04	8.1	Jul	14.0	15.1	(12.8)	(6.9)	12.9	13.0	3.1	1.0	6.9	3.7	3.7	3.30	1.8
MRCB	SELL	0.51	0.31	2.2	Dec	109.2	114.9	n.m	(5.0)	35.5	35.7	1.1	0.5	0.4	3.5	3.5	0.89	43.3
WCT	HOLD	0.50	0.37	0.7	Dec	10.4	6.9	(42.9)	44.7	10.3	9.3	2.4	0.2	2.0	3.4	3.4	1.24	59.7
SUNWAY CONSTRU	BUY	1.78	1.94	2.3	Dec	19.4	17.3	(11.3)	12.4	10.1	9.3	0.5	3.5	17.8	3.4	3.9	2.15	17.2
AME ELITE	BUY	1.51	1.52	0.6	Mar	11.9	10.8	8.4	10.2	7.3	6.5	1.5	1.0	8.3	1.7	1.8	3.05	50.5
GABUNGAN AQRS	HOLD	0.82	0.78	0.4	Dec	10.4	10.6	14.0	(1.9)	9.9	10.5	0.7	1.2	7.3	4.9	4.9	1.12	27.2
PINTARAS	HOLD	2.65	2.33	0.4	Jun	8.3	8.8	8.6	(5.6)	3.5	3.4	2.1	1.2	14.9	6.8	7.2	NA	NA
TALIWORKS	BUY	0.85	1.02	1.7	Dec	19.5	25.7	76.2	(24.3)	13.5	17.5	0.5	1.7	8.9	7.8	7.8	1.27	33.5
HSS ENGINEERING	HOLD	0.44	0.32	0.2	Dec	25.4	23.8	>100	6.8	9.8	9.0	0.4	1.0	3.9	0.0	0.0	NA	NA
Average				**23.1**		**18.8**	**18.8**	**(8.6)**	**(0.6)**	**12.3**	**12.3**		**1.2**	**4.1**	**3.7**	**3.8**	**0.00**	**31.0**

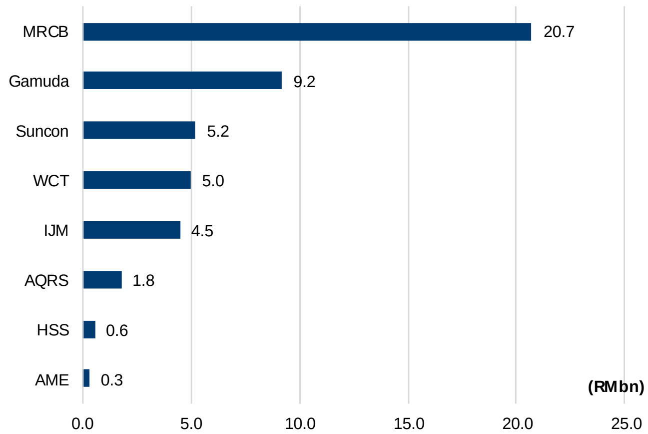
Source: Bloomberg, Affin Hwang forecasts *Note: Pricing as of close on 17 April 2020*

Key risks

Upside risks to our negative sector view: (1) government pump-priming through the revival of key infrastructure projects; (2) pick up in the award of government projects; and (3) faster-than-expected resumption of works on construction projects.

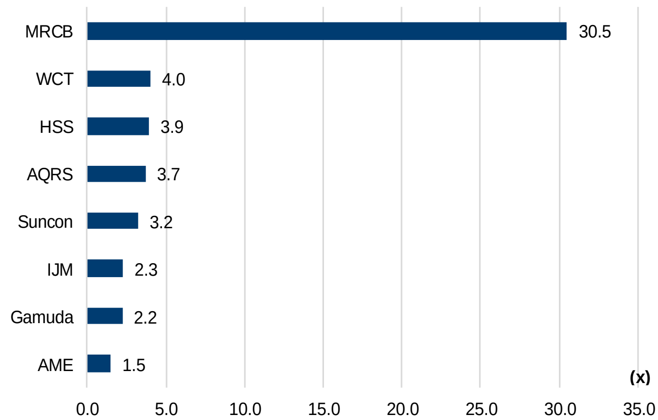
Key focus charts

Fig 10: Construction order book at end-2019



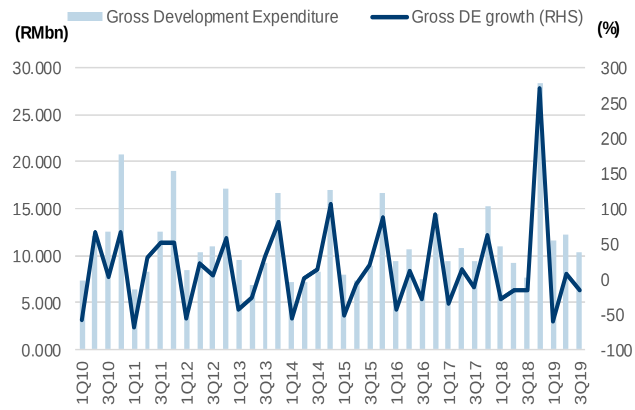
Source: Company, Affin Hwang estimates

Fig 11: Order book/revenue at end-2019



Source: Company, Affin Hwang estimates

Fig 12: Government gross development expenditure



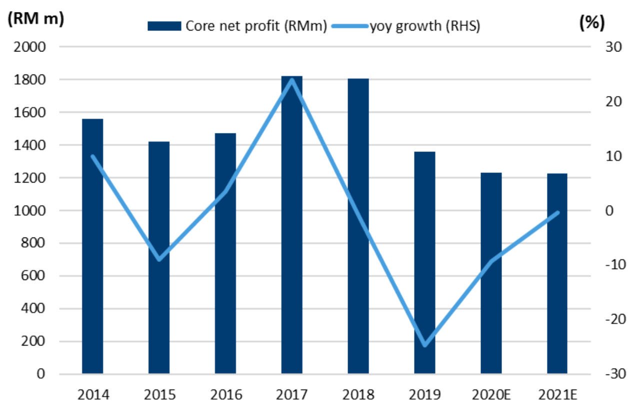
Source: Ministry of Finance

Fig 13: Infrastructure works to be awarded in 2019 onwards

Project	Estimated cost (RMbn)
Penang Transport Master Plan (PTMP)	32
Bandar Malaysia infrastructure	21
Klang Valley MRT Line 3 - Circle Line (MRT3)	21
KL-Singapore High Speed Rail - Fast Train	20
Pan Borneo Highway Sabah (PBH)	13
East Coast Rail Link subcontracts	8
Sarawak Water Grid Phase 1	8
Sarawak Coastal Highway	5
Sarawak Second Trunk Road	6
Labuan Bridge	4
Johor Bahru-Singapore Rapid Transit System	3
Others	10
Total	**146**

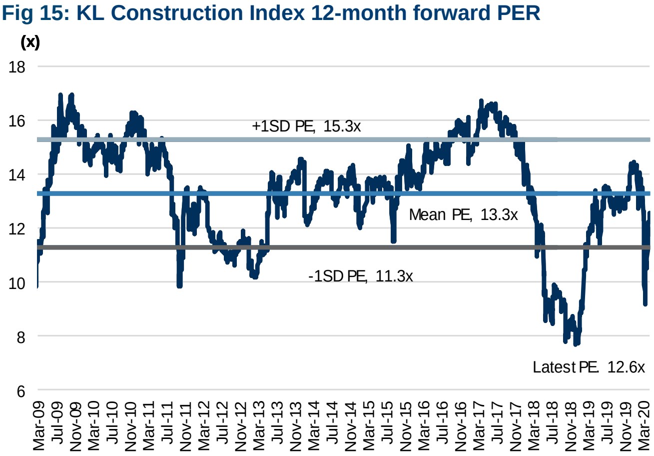
Source: Affin Hwang estimates, various media, eg, The Star and The Edge Financial Daily

Fig 14: Aggregate construction core net profit and yoy change



Source: Companies, Affin Hwang forecasts

Fig 15: KL Construction Index 12-month forward PER



Source: Bloomberg, Affin Hwang forecasts

Out think. Out perform.

Important Disclosures and Disclaimer

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +10% over a 12-month period
HOLD	Total return is expected to be between -5% and +10% over a 12-month period
SELL	Total return is expected to be below -5% over a 12-month period
NOT RATED	Affin Hwang Investment Bank Berhad does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation

The total expected return is defined as the percentage upside/downside to our target price plus the net dividend yield over the next 12 months.

OVERWEIGHT	Industry, as defined by the analyst's coverage universe, is expected to outperform the KLCI benchmark over the next 12 months
NEUTRAL	Industry, as defined by the analyst's coverage universe, is expected to perform inline with the KLCI benchmark over the next 12 months
UNDERWEIGHT	Industry, as defined by the analyst's coverage universe is expected to under-perform the KLCI benchmark over the next 12 months

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