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Edge Weekly

Cover Story: Undervalued stocks worth looking at

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A continuation and revival of mega public infra projects will be the major catalysts for the sector, says MIDF Research (Photo by Kenny Yap/The Edge)

AS shares in Malaysian construction companies dip to almost their lowest level since the pandemic started, many factors are at play to determine whether it is a good time to revisit the sector.

CGS-CIMB Research analyst Sharizan Rozely says the market has priced in the uncertainties in the rollout of new infrastructure projects as well as the ensuing sector recovery. Hence, it may be a good time to take a position in undervalued stocks as the downside is limited, he tells The Edge.

"Prior to GE14, many contractors were trading above one times book value. They are now undervalued across multiple valuation methods.

"But investors need to be selective, choose companies with strong track records and good execution that could benefit from the potential rollout of large-scale projects such as the MRT3 Circle Line."

Similarly, MIDF Research suggests that "the risk and reward factors of the sector have been suitably priced in at this juncture".

"Currently, the Bursa Malaysia Construction Index is trading slightly below its average five-year forward price-earnings ratio (PER), at 10.6 times versus the long-term average of 11.6 times," MIDF Research says in its email reply to The Edge.

Rerating hinges upon clarity on mega projects

However, any excitement in the sector still hinges on the prospects for the MRT3. The reason is that the government's eagerness to kick-start economic growth by pump-priming the construction sector has not translated into the order books of listed construction players, MIDF Research says.

"Select companies under our coverage saw a decline in cumulative order book value from the high of RM40.6 billion in 2018 to RM32.7 billion, or a 20% decline.

"Among large caps on our coverage, only Sunway Construction Group Bhd (SunCon) managed to stem the decline [with] single-digit contraction, at 8%, in comparison to other companies.

However, it is noteworthy that SunCon gets a lot of jobs from its parent, Sunway Group which has a big development business.

"Perennial favourite Gamuda Bhd recorded a 25% decline in its order book value. [Around] 55% of Gamuda's order book is derived from MRT2 jobs, which are already at 83% completion, [which is] slated to be in 2022.

"We reasoned that such worrying trends put a question mark on companies' earnings for the short- and medium-term horizon. We posit that only a continuation and revival of mega public infra projects will be the major catalysts for the sector moving forward," MIDF Research says.

Without MRT3, the short-term outlook is unexciting and valuation levels could remain stagnant, it adds.

CGS-CIMB's Sharizan says, "Every contractor in town is looking for new job opportunities. MRT3 has the highest probability of being relaunched by the government, but that depends on several approvals, including that of the Cabinet."

Investors could play on news regarding which sector has the highest probability of seeing any catalyst in the first half of this year, he adds.

His top stock pick is Gamuda (target price: RM3.88) for its advantage over other bidders for the MRT3 underground package as the incumbent for MRT1 and MRT2.

He also has "buy" calls on IJM Corp Bhd (TP: RM2.17) as it is a contender for the Tier 1 civil works packages of MRT3, owing to its strong balance sheet that could help it meet the private funding requirement.

Analyst picks for infrastructure construction stocks

COMPANY	MARKET CAPITALISATION (RM MIL)	CLOSING PRICE (RM)	FY2022 EPS ESTIMATE (SEN)	AVERAGE TP (RM)	UPSIDE POTENTIAL (%)
Gamuda Bhd	7,037.68	2.80	23.5	3.58	27.9
YTL Corp Bhd	6,249.53	0.57	2.1	0.64	12.3
IJM Corp Bhd	5,040.82	1.42	7.6	1.95	37.2
Sunway Construction Group Bhd	1,908.25	1.48	9.9	1.81	22.1
Malaysian Resources Corp Bhd	1,585.97	0.355	0.9	0.38	8.0
Cahya Mata Sarawak Bhd	1,342.72	1.25	20.2	1.70	36.0
Hock Seng Lee Bhd	741.85	1.35	9.1	1.00	-25.9
WCT Holdings Bhd	722.79	0.51	5	0.63	24.4
Kimlun Corp Bhd	277.39	0.785	11.8	1.16	47.5
Gabungan AQRS Bhd	214.39	0.395	8.2	0.63	60.0

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East Malaysia growth story intact

Meanwhile, East Malaysian construction players' order book replenishment and earnings prospects are seen to be bright in the medium to long term, with Sabah and Sarawak having received the bigger share of the federal budget development expenditure allocation in 2022 of RM5.2 billion and RM4.6 billion respectively.

In addition, the numerous upgrading works of potentially more than 1,800 projects could provide a fillip to demand for cement, concrete and steel pipes, likely benefiting the region's sole cement manufacturer Cahya Mata Sarawak Bhd (CMS), MIDF Research says.

On the RM15 billion Phase 1 Sabah Pan Borneo Highway, the research house sees the new Private Finance Initiative (PFI) approach to benefit players in East Malaysia with a strong balance sheet to stomach the financing requirement. One of them is Hock Seng Lee Bhd (HSL).

"It is the only company which owns a full range of tunnel boring machines for sewer networks in East Malaysia," MIDF Research points out.

The research house's top picks include Gamuda (TP: RM3.63), CMS (TP: RM1.62) for its strong position in East Malaysia, and SunCon (TP: RM1.80) for its defensive and quality earnings outlook on the back of an order book of more than RM4 billion which will last three years.

Other risks could cap upside

Other research houses have maintained their "neutral" calls on the sector, with risks expected to persist across several fronts.

Despite a surge in contract awards for the industry in 4Q2021, HLIB Research remains neutral on the sector "as fluidity of looming elections could weigh on sector sentiment, with investors adopting a wait-and-see approach".

"Our expectations are for a recovery in private sector opportunities and the ongoing rollouts of existing projects like the East Coast Rail Link, Pan Borneo Highway Sabah and Sarawak, the Johor-Singapore Rapid Transit System and Central Spine Road to support job flows in 2022," it says in a Jan 10 note.

"Sector valuations are on the lower end at 12.9 times forward PER (five-year average) and 0.65 times price-to-book (P/B) ratio (-1 standard deviation on five-year range).

"Recent news flow on critical projects like MRT3 is encouraging but we remain cautious on the timeline and overall sector earnings execution amidst the ongoing virus spread."

The research house has "buy" calls on SunCon (TP: RM1.77) owing to its strong balance sheet, extensive track record of infrastructure projects and strong support from Sunway Group, as well as Kimlun Corp Bhd "for its solid order book, decent job visibility and niche exposure to MRT3, alongside attractive six times PER and 0.35 times P/B ratio".

Maybank IB Research, in its December 2021 note, writes that the "continuous rise in material cost and labour shortages will cut into margins for jobs already secured".

Covid-19 risks also remain, while stalled order book replenishment from delayed major infrastructure project rollouts may lead to an "earnings cliff" in 2023/24 as existing projects are completed, it adds.

Nonetheless, the bank-backed research house's preferred buys include IJM (TP: RM2.20) and Gamuda (TP: RM4), as their strong balance sheets will enable them to take on private sector funded projects anticipated under the public-private partnership (PPP) 3.0 model, which could come into the picture this year. It also has a "buy" call on CMS (TP: RM1.68).

Other analyst picks in the construction sector include Gabungan AQRS Bhd, WCT Holdings Bhd and YTL Corp Bhd.