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Construction sector enters new paradigm

The industry is undergoing a major shake-up. For the players, the game is changing. Who will survive, and who will fall?

The construction sector, which enjoyed a good run until recently, is seeing a massive shake-up following the 14th general election last May.

Fund managers and analysts say various measures, in particular the cancellation and deferment of several mega projects, have caused a drastic shift in the sector's fundamentals. New processes to increase transparency and governance is also changing the state of play.

Industry observers note that as with all reforms, the short-term fallout will be painful. But in the longer term, they will have a positive impact.

Clement Chew, CEO of Apex Investment Services Bhd, who has been involved in the financial industry and stock market for more than 20 years, had never seen any of the previous administrations practise such scrutiny on construction costs. "The current administration is really scrutinising the costs, deliverables and what is deemed a fair return to the companies. We have moved into a new paradigm," he says.

Chew adds that the feedback he gets from corporate figures confirms this view. "They told us that they have to adhere to very specific guidelines now when submitting proposals to the government for an open tender or to renew concessions. The government looks at every line carefully to see why you are making that amount of money.

"This is a good development. I think it will be hard for us to go back and do things the way they were done in the past. The processes are already in place and it will be hard to change that. Now, we see people in the government fighting to help save taxpayer money."

The review of the Mass Rapid Transit Line 2 (MRT2) and Light Railway Link 3 (LRT3) are two good examples of such scrutiny, he points out. The construction cost of these infrastructure projects was cut by 47% and 22.4% respectively. This has helped the government save a total of RM23.84 billion. In addition, the construction of the East Coast Rail Link (ECRL) and Kuala Lumpur-Singapore High-Speed Rail (HSR) has also been put on hold and reviewed.

Construction companies that were able to bag government projects due to their close relationship with key figures in the administration can no longer do so, says David Loh, portfolio manager at Affin Hwang Asset Management Bhd. "The construction sector is highly vulnerable

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Construction workers connecting parts of a crane at a building site in Kuala Lumpur. Malaysia's economic growth eased in the second quarter of last year, the central bank said on Aug 12, attributing the slowdown to a decline in exports amid subdued global demand.

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Performance of the top 10 companies on the Bursa Malaysia Construction Index

NAME	MARKET CAPITALISATION (RM MIL)	SHARE PRICE AS AT JAN 29 (RM)	SHARE PRICE AS AT JAN 3, 2018 (RM)	PER AS AT JAN 29 (TIMES)	P/B AS AT JAN 29 (TIMES)
Gamuda Bhd	6,663.74	2.70	4.73	13.75	0.85
IJM Corp Bhd	6,382.29	1.76	2.70	26.83	0.69
Sunway Construction Group Bhd	2,028.83	1.57	2.26	14.50	3.62
Kerjaya Prospek Group Bhd	1,531.52	1.24	1.54	11.24	1.62
Muhibbah Engineering (M) Bhd	1,358.44	2.82	3.03	9.45	1.21
WCT Holdings Bhd	1,125.18	0.82	1.49	6.85	0.35
Ekovest Bhd	1,123.10	0.53	0.98	9.50	0.55
Hock Seng Lee Bhd	763.83	1.39	1.62	13.43	0.99
Econpile Holdings Bhd	642.00	0.48	1.16	7.93	1.67
George Kent Malaysia Bhd	593.83	1.10	4.14	5.85	1.24

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to corruption by nature due to its size and the complexity of the contracts. But the situation has changed under the new government.

"One focus of the new government is to implement reforms to tackle graft. It came as no surprise that it immediately suspended and reviewed all large public projects after GE14. The administration has been consistently sending out messages to all ministries that all jobs will be awarded based on open tender going forward.

"Thus, bids [for construction projects] will be evaluated based on merit, taking into account construction cost and the technical capability of the construction companies. This will eliminate special treatment for people who rely on close ties [to secure projects]."

Companies with perceived links to the previous government tended to be awarded lucrative projects, but this will no longer be the case, says Yip Kah Meng, equity research analyst at Hong Leong Investment Bank, who covers the construction sector. "In the past, the profit margin of these contracts could go up as high as 20%. Now, according to industry players, 5% to 6% is the new normal. This is a significant drop and is definitely a telling sign that there has been a structural change in the industry."

BARGAIN-HUNTING TIME FOR BUY-AND-HOLD INVESTORS

The new paradigm represents a good opportunity for investors to bargain-hunt for stocks in the sector, say fund managers and analysts. Valuations have become cheap. The share prices of many construction companies have fallen to multi-year lows post-GE14, so the downside is limited.

"The price of the sector has almost halved and there was a big correction in the stock prices of many companies. The sector looks attractive from a value perspective," says Chew.

He notes that the Bursa Malaysia Construction Index has a one-year forward price-earnings ratio (PER) of 8.4 times as at Jan 14. The sector's PER was 16.6 times at its peak in June 2017 and 10.6 times in September 2018.

The sector's price-to-book value (P/B) was 0.7 times on Jan 14. It was at 2.03 times during its peak in December 2007 and one time in December 2008.

"Analysts have revised downwards their earnings expectations [on the sector] as there was a lot of negative news coming out. But there is not much downside going forward," says Chew.

Devan Linus Rajadurai, CEO and chief investment officer of MTC Asset Management, agrees. He points out that the share prices of many construction companies have fallen drastically. "Many companies have seen their share prices tank by more than half. Things have bottomed out and it is all about stock picking right now," he says.

The bad news for the sector is already reflected in the current share prices, says Yip. "If you are a buy-and-hold investor, it is a very good opportunity to accumulate now."

Also, he does not expect the earnings of construction companies to pick up in the

MOHD IZWAN MOHD NAZAM/THE EDGE

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short term as there are not many catalysts for growth. Loh concurs, saying that he has a neutral outlook on the construction sector over the short term as companies' earnings are expected to remain flat going forward.

However, government-awarded construction projects are expected to start rolling in again over the longer term. "The government will probably come out with some new projects as we head towards the next general election," says Chew.

Devan concurs. "Let's not forget that we are an emerging market and building infrastructure has always been the way for the government to grow our economy."

NEW ENVIRONMENT STILL FAVOURS THE BIG BOYS

Fund managers still favour large construction counters going forward. These companies are in a better position to withstand a challenging environment where profit margins are compressed due to the government's scrutiny on construction costs.

Chew says companies such as IJM Corp Bhd, Gamuda Bhd and Sunway Construction Group Bhd (SunCon) are expected to outperform their smaller counterparts. They can bid competitively under the open tender system due to their strong balance sheets, experience, technical capabilities, machinery, manpower and economies of scale to purchase raw materials in bulk at lower prices.

These companies are able to take on mega infrastructure projects without the need to partner up or rely on other parties, he adds. "Companies that rely more on sub-contractors and other parties [to provide them with technological support] have to split their profits. This makes them less able to bid competitively."

IJM, Gamuda and SunCon were able to weather the economic recession in the 1980s and the two financial crises in 1997/98 and 2008, says Chew. "They tend to come back stronger than before."

Chua Zhu Lian, director of research at Fortress Capital Asset Management Sdn Bhd, says the government is more likely to award contracts to the big boys to avoid delivery risk. "I do not foresee smaller companies climbing up the ladder. The big players will probably be here to stay due to their higher efficiency and ability to bid for contracts at a lower cost.

"It is also quite risky for the government to replace these big players with smaller ones. What if a project is not well executed and something collapses? This risk will be too costly for them."

Loh agrees, saying that the large companies could gain more market share while smaller ones have more to lose. "The new environment favours the big boys. When they do not have big jobs, they go for smaller ones. They are in a much better position to weather this low period."

IJM, GAMUDA, SUNCON THE TOP PICKS

Among the large counters, Chew favours Gamuda. "It has very good engineering and construction capabilities and it is well run. The company has accomplished some challenging projects such as the Stormwater Management and Road Tunnel (Smart Tunnel)," he says.

As at Jan 18, the stock was trading at RM2.80 a share, with a PER of 14.26 times and P/B of 0.89 times.

Yip, however, favours IJM and SunCon. He expects the two companies to bag more government projects under the open tender system and will adapt better to the new environment.

IJM and SunCon are good companies even though they have not won many construction projects from the government. While Gamuda is also a good company, it has relied more on government contracts. This has provided the company with lucrative profit margins of up to 20% compared with the market rate of 5% to 6%.

"The industry players with whom I have spoken say companies such as Gamuda will have to settle for lower margin jobs and adapt to the new environment. By comparison, companies such as IJM and SunCon have been getting margins of 5% to 6%. So, they will adapt more easily."

Yip says he will avoid companies with a weak balance sheet such as WCT Holdings Bhd. "Its debt-to-equity ratio is high even though it has a healthy order book. The ratio is about one time compared with the industry average of about 0.5 times."

He advises investors to avoid construction companies that have huge exposure to the property market as it currently remains weak.

Loh favours Kerjaya Prospek Group Bhd, a mid-sized construction company involved in residential property projects. The company has been enjoying good profit margins and has a strong balance sheet with a lot of cash, he says. "The profit margins are good as the company is building properties for premium developers such as EcoWorld International Bhd and Eastern & Oriental Bhd.

"It is important that the companies have a lot of cash as they will be able to ride out the sector slowdown better than their peers. Don't forget, we are also in a rising interest rate environment. So, companies with a huge cash pile will earn more in interest while those with a high level of debt will have to pay more." ■ By Kuek Ser Kwang Zhe

SHAHRIN YAHYA/THE EDGE

"Many companies have seen their share price tank by more than half. Things have bottomed out and it is all about stock-picking right now."
> Devan