

Less hype, more implementation

Getting the job done is critical in winning over long-term sceptics

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Heavy machinery has been deployed, sites are being cleared, hoardings and barriers have been erected; a tour of the major construction sites around Kuala Lumpur provides definitive evidence of the pleasing progress being made in the broader construction sector.

It is a positive step forward for the market, especially given Malaysia's past reputation for being "long on hype and short on project execution" in the infrastructure sector.

The kick-off of high impact projects is significant. We have seen the commencement of mega projects such as the RM20 billion Sungai Buloh-Kajang mass rapid transit (MRT) line, for which ground works have already begun at a number of sites, near Jalan Semantan. The RM7 billion light rail transit (LRT) extension is also well under way, with elevated guideway structures clearly visible.

Smaller projects are also taking shape. For example, sidewalks along busy parts of the Kuala Lumpur Central Business District are being dug up as part of a major upgrade. These projects are part of the Economic Transformation Programme (ETP) to make Kuala Lumpur a destination of choice. Major air-conditioned elevated covered walkways, similar to Central in Hong Kong, linking the Kuala Lumpur City Centre to Pavilion have just been completed.

The infrastructure initiatives are now visually and economically self-evident from the large projects such as the LRT, MRT and Kuala Lumpur International Airport 2, to smaller

"day-to-day" type projects such as improvements to rural roads. What is also pleasing is the recommencement of private sector-led infrastructure initiatives such as the RM7 billion West Coast Expressway.

We are fully aware that Malaysia has had its fair share of white elephant projects, especially pre-Asian crisis projects like Bakun Hydroelectric and Perwaja Steel plant. Of late, there have been questions raised whether the recently announced "new" infrastructure initiatives truly add value or are simply a shot in the arm for the economy.

However, from the list of major construction projects announced so far, most are necessary long-term infrastructure "support" projects, including water supply projects, the construction of teaching hospitals, and the development of a new low-cost airport terminal and much-needed public infrastructure. Anyone who had been to Kuala Lumpur in recent years would have experienced or seen the congestion in the city and the somewhat lack of an orderly and well thought through public transport system. It is good to see this is being addressed with Line 1 due for completion by 2016 and operational by 2017.

Since the start of the year, a number of high profile projects has been awarded, which has led to the construction sector outperforming the FBM KLCI. In addition to the estimated RM10.6 billion worth of domestic construction jobs awarded so far in 2012, we believe there are still large jobs to be tendered out this year, including RM18 billion worth of MRT projects, the RM8 billion Gemas-Johor Baru double track rail project and five other highway privatisation jobs. These are notwithstanding capacity replacement of first-generation power purchase agreements expiring in 2015/2016 and the RM13 billion to RM14 billion worth of power plant construction contracts to be tendered out, too. These "productive" jobs should address the country's desperate need for a more comprehensive public transport network.

More importantly, this is certainly a bullish backdrop for listed contrac-



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tors and building material suppliers, as we expect news flow around project awards to stay high.

At a micro level, Malaysia is heavily dependent on foreigners for "heavy lifting" in the construction industry. Limited "supply" of workers from countries such as Indonesia is potentially a risk, particularly when employment opportunities at home have improved significantly over the last five years. Also, infrastructure pump priming is unlikely to be nationwide. Yes, there will be the usual road upgrades in rural areas, but high impact projects are likely to be concentrated in areas such as Greater Kuala Lumpur, Johor (Iskandar Malaysia) and Sabah and Sarawak.

We must also not forget 2007/2008 when commodity prices spiked, which ultimately led to surging building material prices. As a result, several projects stalled and many were put on hold. Margins collapsed and several smaller contractors vanished. With the oil price staying above US\$100 (RM303)/barrel and major economies such as China and the US showing signs of recovery, we should not be ruling out a higher cost environment in the near to mid term.

But the most significant concern by far would be politics, given that we are likely to see a general

election in 2012. If the opposition coalition wins, the risk of several megaprojects being put on hold or contracts being renegotiated will most likely be high.

However, what is encouraging is that the economy is benefiting from the government's fiscal spending. In 4Q11 alone, government consumption contributed 20% to GDP growth, the highest level since 2005, offsetting weaker exports. The Malaysian economy expanded at a much faster pace than expected in 4Q11 (1.3% q-o-q in 4Q versus 1.2% in 3Q and 0.6% in 2Q), bringing full-year growth to 5.2%, a full percentage point above our forecast. Based on infrastructure-related jobs released so far and what is visible to the eye, we expect current fiscal spending trends to persist as global economic uncertainty continues, and to affect overall market earnings, which we now forecast to grow 12.4% in 2012, with upside bias.

The construction sector has historically traded at premium price-earnings ratio (PER) valuations relative to regional peers. We believe this is largely due to historical trapped domestic liquidity as well as higher profit before tax (PBT) margins of mid to high single digits for domestic jobs. At current prices, the construction sector is

trading at mid-cycle valuations of 14.8 times one-year forward PER. This may not seem appealing at first glance but the sector offers a 2012 earnings per share compound annual growth rate of 20% and history suggests that government contracts tend to accelerate in the run-up to a general election, which our research reveals is likely to be this year.

Foreign shareholding in the Malaysian market has stayed relatively flat over the last 18 months. There are several reasons for this but our study has revealed that a poor track record in project implementation over the last five years certainly ranks highly as a reason why investors are avoiding the market. We believe the ETP is making reasonable progress in certain areas but Malaysia's restructuring proposition requires a longer period of "getting the job done" before the market is able to win over long-term sceptics.

The construction, building materials and infrastructure support sector is relatively small at less than 5% of Malaysia's total market cap. However, the knock-on effect on the economy should filter through relatively quickly. As we discussed earlier, fiscal spending has already made quite an impact in 4Q11 and this is likely to persist. Furthermore, 2011 was a record year for foreign direct investment (third in Asean after Indonesia and Singapore), amounting to RM32.9 billion, and this is likely to have an impact on the economy, too.

In short, we are positive on the construction names, but also realise that these mid-caps may be too small for those managing larger mandates. Generally, for indirect proxies to fiscal spending, we suggest exposure through larger banks with relatively high corporate exposure.

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