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Smaller construction firms buoyed by gradual improvement in economy

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Small construction players listed on Bursa Malaysia appear to be the major beneficiaries of a nascent recovery in the economy, although contracts secured from the private sector tend to be less than RM100 million.

Large contracts are hard to come by, owing to Putrajaya's tight fiscal position. Small contracts such as those to build affordable houses are currently being awarded, according to industry insiders. And these contracts are mostly won by the smaller players rather than the big boys, with the contracts in the market at the sub-RM100 million level, they say.

"There are many tenders being called and projects awarded, albeit maybe in smaller, step-by-step packages rather than large contracts. The private sector is more active than the government these days," says an insider who monitors the construction industry.

The industry is back on the radar screens of investors as talk of a general election — possibly after August — has raised expectations that the Perikatan Nasional government will pump-prime the economy.

Already, one of the biggest infrastructure projects in the country, the Mass Rapid Transit Circle Line (MRT3), is back on track. The project is estimated to cost between RM20 billion and RM30 billion and the jobs are expected to be farmed out beginning in August.

Analysts have upgraded construction stocks and raised their target forward price-earnings ratios (PERs). "To reflect the improved trading sentiment towards construction stocks on the back of the latest news (MRT3), we raise our benchmark target forward PER of large- and mid-cap contractors to 14 times from 12 times and of small-cap contractors to nine times from eight times," AmInvestment Bank analyst Joshua Ng wrote in an April 5 sectoral report.

The construction industry was upgraded to "neutral" on the day after the government confirmed that the Cabinet had agreed to go ahead with the MRT3, albeit with different specifications from the original alignment, which would have seen the entire line underground.

During a media briefing by MRT Corp, its CEO Datuk Mohd Zarif Hashim revealed that the state-owned entity is looking for private sector funding of up to 30% for the

MRT3 to reduce the government's burden. However, details on how the private sector can participate in funding the MRT3 have yet to be made available.

When the first line of the Klang Valley MRT project was launched in 2012, a DanaInfra Retail Sukuk worth an initial RM100 million was launched by the government to help fund the construction.

A banker who spoke to *The Edge* says the private sector would like to contribute to the funding of the MRT3, provided that the credit has been secured and repayment sources clearly identified. This means the project must have strong cash flow.

Despite positive news flow on the MRT3, the fluid political landscape is a challenge for implementing big infrastructure projects. Without a clear mandate, the government remains on treacherous ground.

Ng noted in the sectoral report that although government approval for the MRT3 project has boosted market sentiment, the dynamics of the political landscape may work against it. Moreover, the government's fiscal constraints will push infrastructure projects towards public-private partnerships, in which the main contractors may be required to take on certain operating or commercial risks and/or participate in the funding of the project, he pointed out.

Ng cited the East Coast Rail Link (ECRL) and Island A of the Penang Transport Master Plan (PTMP) as good examples of how partnerships could be formed between the government and the private sector.

Nevertheless, if the private sector is required to take on certain risks and participate in the funding of the projects, it may affect the valuations of the companies involved. For example, Ng's target forward PER for Gamuda Bhd is one time lower than the research firm's benchmark target for the construction industry to reflect the higher risk taken in the reclamation of Island A of the PTMP.

While the MRT3 could be a catalyst for the construction industry, it is the smaller jobs that are expected to sustain the industry. For example, in January, Advancecon Holdings Bhd announced that its wholly-owned subsidiary, Advancecon Infra Sdn Bhd, had bagged a RM60.6 million subcontract for the proposed construction and completion of subgrade works for Package 3, Section 4 of the ECRL.

Last month, Advancecon secured another

subcontract, for ground treatment works in the ECRL project, worth RM14.6 million. The group has been awarded a total of five subcontracts for the project since the middle of last year, valued at RM185.8 million.

The contract wins had pushed its share price up 53.6% over the last 12 months to close at 43 sen last Thursday, valuing the company at RM176.8 million. At that price, the stock was trading at an FY2020 earnings per share of 81 times. This was despite the company's earnings taking a hit last year, slipping to RM2.1 million from RM10.83 million in the previous year.

Advancecon has piqued analyst and investor interest as it recently secured a quota of 26MW under the fourth cycle of the Large Scale Solar (LSS4) project. On April 20, RHB Research Institute initiated coverage, with a target price of 54 sen and a "buy" call on the stock.

Danial Razak and Eddy Do Wei Qing, who penned the report, say they like Advancecon for the following reasons: it is a leader in earthworks; it is a front runner for new development projects; it has a higher order book of RM881 million, compared with RM572 million pre-listing; and it has ventured into the solar industry.

The RHB Research analysts estimate that the solar power venture could boost Advancecon's earnings by 13% in FY2024E. "Management expects this segment to provide a recurring income stream that will complement its core business and civil engineering unit."

"Over the next 21 years, Advancecon aims to book at least RM1 million in net profit from this business. Note that the recent win of LSS4 project has the potential to boost its net profit by 13% year on year in FY2024E."

The analysts' target price of 53 sen per share is derived by pegging FY2022F earnings per share to a PER of 12 times. The multiple represents Advancecon's five-year mean baseline, which is warranted as its earnings are returning to pre-pandemic levels, they say.

The company also has a healthy replenishment rate assumption of RM300 million and RM350 million for FY2021F and FY2022F respectively. The analysts' target price was derived after imputing the LSS4 project win.

Another company that has been bagging small contracts is Gagasana Nadi Cergas Bhd. In March, Nadi Cergas said it had been awarded a RM97.39 million contract by the Public Works Department to build a Maktab Rendah

Sains Mara campus in Dungun, Terengganu.

While Nadi Cergas has secured only one construction contract so far this year, it is building on the RM777 million contract secured in July last year from the Selangor government to build 4,319 units of affordable homes. With the inclusion of the Rumah Idaman contract, its order book stood at RM1.2 billion in July last year, although the figure may be different now.

Nadi Cergas' share price has rallied 39% in the last 12 months to close at 32 sen last Thursday, giving the company a market value of RM237.2 million. The stock is currently trading at an FY2020 PER of 19.3 times.

With the domestic scene less vibrant, more companies are looking abroad for jobs. Last year, Sunway Construction Group Bhd won two highway projects worth more than RM800 million in India, while Gamuda has been shortlisted for three motorway and metro line projects in Australia.

Nevertheless, analysts believe that most of the construction companies they cover have healthy order book levels that can sustain them over the next two years. However, these orders have yet to be translated into works on the ground.

"It is already well known that construction players have enough orders to sustain them for at least two years. If you track the quarterly order book, most contractors at end-2020 had enough orders to sustain them in 2021," says a senior analyst who covers the industry.

"However, the burn rate has come off because some works have not been ramping up steadily," he says. This means that while their order books are big enough and could last the companies for years, they may not necessarily translate into better earnings this year and next.

That is because some project owners and developers are stretching the construction timeline or putting off launches as the economic scenario remains uncertain. The government has also been stretching the timeline of its infrastructure projects.

For example, the Light Rail Transit Line 3 was supposed to be completed in 2021. However, the Pakatan Harapan government decided in 2018 to extend the project timeline to 2024 to reduce its annual cash outflow.

The construction of the MRT3 will also be extended to over 10 years from the original projection of six to seven years. ■