WCT Engineering

Flying high

Initiation
Overweight

M$5.50

22 August 2007
Price Target: M$6.40

Malaysia
Construction
Emerging Growth

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Seedlings

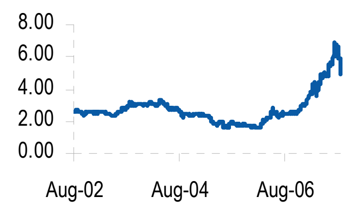
- **We initiate on WCT Engineering with Overweight** and a Dec-08 PT of M$6.40, implying 16% upside. WCT's business model is similar to that of its peers, IJM and Gamuda, yet WCT trades at a 0.26 MC-to-orderbook ratio, a significant discount to IJM's 0.88 and Gamuda's 0.65. We also like it for its large exposure to the Middle East construction market, with involvement in seven infrastructure projects, and over 60% of its existing orderbook coming from that region. We are confident of WCT's execution, and forecast a project win rate of M$700MM per annum.
- **Key drivers–orderbook and WCT Land:** To supplement its existing orderbook of M$5B, WCT has tendered for projects worth M$9B, M$2B of which it deems to be realistic. The existing orderbook is 5x the construction revenue booked in FY06. We also envisage a recovery of WCT's property arm from FY08E onwards. Based on a current GDV of M$2B, we expect the property segment to contribute up to 40% of total OP by FY09.
- **Up the value chain = re-rating:** With the onset of a larger asset base, the group is evolving into a full-scale contractor, ultimately commanding higher pricing and margins for its contracts. We see this as the prime catalyst for an upward re-rating of its multiples vis-à-vis local peers.
- **Valuation, price target, key risks:** While the growth is back-loaded, we feel that construction momentum is strong, and we forecast an earnings growth of 11% for FY07 and 72% for FY08. Our PT is derived from fully diluted SOP, and we highlight project execution and potential margin compression as the key risks.

Bloomberg: WCT MK, Reuters: WCTE.KL
M$ in millions, year-end December

	FY06	FY07E	FY08E	FY09E
Sales	1,400.4	1,663.7	2,414.1	2,777.0
Core net profit	88.1	98.1	169.1	192.6
Core net EPS (sen)	41.3	38.1	56.0	63.7
Net DPS (M$)	0.2	0.2	0.2	0.2
Net profit growth (%)	7.6%	11.4%	72.3%	13.9%
EPS growth (%)	2.1%	-7.8%	47.0%	13.9%
ROE (%)	14.9%	13.4%	19.7%	19.2%
P/E (x)	13.8	15.0	10.2	8.9
P/BV (x)	2.0	2.0	2.0	1.7
Net dividend yield (%)	2.6%	2.6%	2.6%	2.6%
Dividend payout ratio (%)	36%	39%	27%	24%
	3Q06	4Q06	1Q07	2Q07
Sales	218.7	416.3	585.1	550.7
EPS (sen)	8.1	10.3	13.2	12.5

Source: Company reports, JPMorgan estimates.

Five-year share price performance



Source: Bloomberg.

Performance

	1M	3M	12M
Absolute (%)	-0.9	-7.1	117.8
Relative (%)	-14.0	-20.1	85.0

Source: Bloomberg.

Company data

52-week range (M$)	2.43-6.9
Market cap (M$MM)	1,665
Market cap (US$MM)	479
Shares outstanding (MM)	302.8
Free float (%)	57%
Avg daily volume (MM)	0.93
Avg daily value (M$MM)	5.56
Avg daily value (US$MM)	1.60
KLCI	1255.39
Exchange rate (M$/US$)	3.48
Year-end	December

Source: Bloomberg.

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Company description
WCT Engineering was founded on 14 January 1981, with the initials representing the surnames of its founders, Wong, Chan and Taing. It became a public company on 1 April 1994 and made its debut on the Second Board of Bursa Malaysia on 16 February 1995. The company was elevated to the Main Board on 7 January 1999.

WCT is a group of companies with businesses in civil engineering, building & infrastructure construction, property development, property investment, and highway concessions. Over a period of 25 years, WCT has completed over 300 construction projects, valued at over M$5.4 billion. WCT is one of the Malaysian pioneers that ventured into the Middle East, having stamped its presence in Qatar and Bahrain.

In property development, WCT Land is the listed subsidiary of WCT, and the parent company owns an effective 67% stake in WCT Land. In infrastructure, WCT broadened its income base with equity ownership in three toll highway concessions in India.

Corporate governance metrics

Company dividend policy	Dividend track record
Not defined	NA, but historically 15% p.a.
# Days to publish quarterly report	# Days to consolidated annual report
60 days	180
% Independent directors	Inter-company transactions
3/10	NA
History of share placement	Insider ownership (%)
NA	22% – WCT Capital (founding members)

Source: Company and JPMorgan estimates.

Positive price drivers

A cheaper contractor: We conclude that WCT's business model is fundamentally similar to its larger peers, such as IJM and Gamuda, and yet WCT is trading at a more favorable multiple. Based on existing market cap, the company is trading at 0.26 MC-to-orderbook ratio, which is a significant discount to IJM's 0.88 and Gamuda's 0.65. The group has also gradually drifted away from its roots of being a subcontractor, having undertaken large-scale infrastructure jobs on its own. To further supplement its existing orderbook of M$5 billion, WCT has tendered for construction projects worth over M$9 billion, M$2 billion of which it deems to be realistic. The existing orderbook of M$5 billion represents about 5x the construction revenue booked in FY06, in line with its peers.

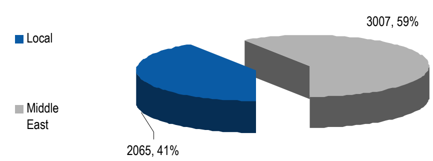
Table 1: Orderbook comparison

Company	Orderbook (M$ B)	FY06A / FY07A (M$ B)	Orderbook / Revenue (x)	Market cap (M$ B)	MC-to-O (x)
Gamuda	10.0	0.7	14.8	6.48	0.65
IJM	6.5	1.1	5.8	5.71	0.88
WCT Engineering	5.0	1.1	5.2	1.51	0.26
Zelan	5.2	0.6	8.9	2.23	0.45

Source: JPMorgan estimates. Note: As of 17 August 2007.

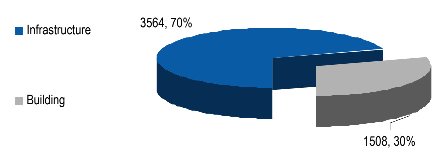
A play on the Middle East: With seven infrastructure projects in the bag, and with over 60% of its existing orderbook coming from the Middle East (ME), WCT has benefited tremendously from the surge in infrastructure spending in that region. Given WCT's experience in infrastructure developments, ranging from airports, highways, dams and racetracks, the company's technical expertise certainly marries well with the development needs of the ME region. While other Malaysian contractors, such as IJM and Gamuda, have also ventured into the ME aggressively, we feel that WCT is in a better position to inherit more projects going forward by virtue of: (1) relationships with local authorities and contractors in the ME; and (2) lower pricing due to its experience as a subcontractor. We are confident of WCT's execution abilities despite the challenging terrain, and we forecast an orderbook replenishment rate of M$700 million per annum attributable to the ME region.

Figure 1: Orderbook by geography
M$ MM, %



Source: Company, JPMorgan estimates.

Figure 2: Orderbook by type
M$ MM, %



Source: Company, JPMorgan estimates.

Experience and niches will lead to margin expansion: With the onset of a larger asset base and as its repertoire of projects increase, we expect WCT to command a higher pricing premium in the market, which will inevitably lead to a margin expansion in the long run. The company has also developed two special niches in infrastructure development over the past 10 years—airports and racetracks. The company is building three airports concurrently—Doha (Qatar), Dubai (Emirates), and Kota Kinabalu (Malaysia). Furthermore, WCT has recently won the mandate to develop the Abu Dhabi Formula 1 racetrack, and this comes over and above the

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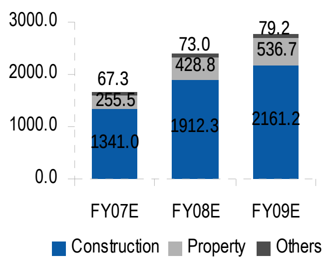
Table 2: WCT—Current orderbook

Projects	(M$ MM)
Bakun Dam, Sarawak	59
KASEH Highway, NS	290
Bukit Tunku Houses, KL	61
Putrajaya Lot 3C4	66
Putrajaya Lot 2G3 & 2F4	41
Tijani Apartments, KL	140
Milau Dam, Sabah	99
UTM Campus, Selangor	424
AEON Bukit Tinggi	267
KK Airport, Sabah	618
Doha Airport, Qatar	749
Dukhan Highway, Qatar	206
Bahrain City Center	509
Abu Dhabi F1 Circuit	1,300
Jebel Drainage, Dubai	243
Total	5,072

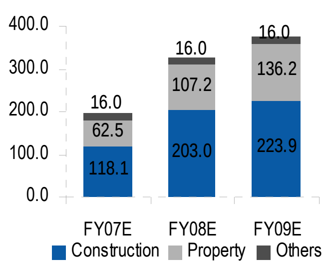
Source: Company, Bursa Announcements.

Figure 3: Sales forecast breakdown



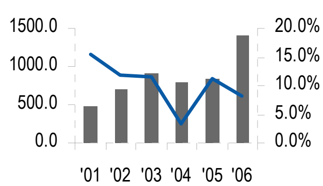
Source: JPMorgan estimates.

Figure 4: Op. profit breakdown



Source: JPMorgan estimates.

Figure 5: Revenue (LHS) and pre-tax margin (RHS) historical trends



Source: JPMorgan estimates.

Bahrain and Sepang circuits it completed in the past. We expect operating margins to stabilize at 8-10% for ME projects, and 10-12% for local projects in the long run.

WCT Land, a growing property arm: We envisage a sharp recovery of WCT's listed property arm, WCT Land, from FY08 onwards. Based on a current GDV of M$2 billion, we expect the property segment to contribute up to 40% of the group's overall operating profit by FY09. While the weakness of WCT's property segment in FY06 can solely be attributed to slow launches, we expect FY08 to witness a recovery in sales as management steps up its launches in conjunction with the completion of an adjacent mall (AEON Mall). WCT's existing developments are:

1. **Bandar Bukit Tinggi**, a mixed development in Klang Valley, with M$1.4 billion of remaining GDV stretched over the next five years;
2. **The Paradigm**, a commercial development in Klang Valley, with M$400 million of GDV spanning over 12 acres of land;
3. **D'Banyan**, a high-end residential project in Kota Kinabalu, with M$227 million of GDV spanning over 22 acres of land.

WCT is also close to announcing its inaugural property development project in Ho Chi Minh City, Vietnam. Following the footsteps of other Malaysian companies such as Gamuda and SP Setia, we see strong potential in this venture given the property boom cycle in Vietnam. Early indications point to a mix of commercial development and high-rise condominiums, with GDV being in excess of M$1.5 billion.

Table 3: Property development breakdown of WCT Land, a 66% subsidiary of WCT Engineering

	Township			Commercial	Residential	
	BBT1	BBT2	BBT3	Kelana Jaya	KK	Total
Land Area (acres)	347	562	427	12.4	21.5	1370
Land Cost (M$ M)	175	140	115	83	57	570
Land Cost (M$ psqft)	11.6	5.7	6.2	153.7	60.9	238
GDV (M$ MM)	1191	1492	919	402	227	4231
Sales to-date (M$ MM)	1002	1112	99	-	-	2213
Billings to-date (M$ MM)	971	1025	52	-	-	2048
Unbilled Sales	31	87	47	0	0	165
Unsold GDV	189	380	820	402	227	2018

Source: Company, JPMorgan estimates.

Negative price drivers & risks to thesis

Middle East market remains risky: While most Malaysian contractors have ventured aggressively into the ME over the past five years (as a move to grow independent of the Malaysian construction cycle), project execution has been very difficult for most of them. Cost overruns are severely punished for ME projects due to the strict contractual terms on penalties, and the sourcing of building materials can be very expensive if not hedged correctly. The group's first two projects in Qatar (Dukhan Highway and Doha Airport) are facing cost overruns and are likely to be unprofitable. Despite that, we believe management has learned its lesson in contract negotiations, and the experience from the two projects in Qatar has led them to better understand the terrain for future projects.

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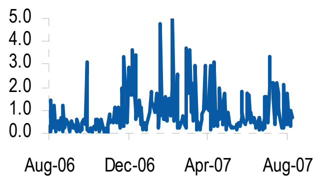
Figure 6: One-year historical trading volume (MM shares)



Source: Bloomberg.

Table 4: Share dilution

Total cum bonus	302.2
ICPS dilution*	50.4
CB dilution*	47.7
ESOS remaining	10.0
Total FD share base	410.3
Amounts raised	
ICPS	151.1
Convertible bonds	262.5

Source: JPMorgan estimates.
* Assuming ICPS and CB to be converted at current market price of M$5.50 per share.

Table 5: Shareholding structure

Free float	≈ 62%
Foreign shareholding	≈ 25%
Top-3 largest shareholders	
WCT Capital	≈ 22%
EPF	≈ 16%
Invesco	≈ 6%

Source: Company, JPMorgan estimates.

Execution pressure from rising costs: Building materials inflation in Malaysia is likely to continue to apply downward pressure on construction margins and property development cost. In comparison to 2006, building materials such as cement (over 10%), steel (over 20%), and concrete piles (over 20%) have risen on the back of stronger demand, buoyed by the 9MP.

ICPS and convertible bonds dilutive: The group has recently raised funds worth M$414 million—a combination of M$155.1 million in irredeemable convertible preference shares (ICPS) and US$75 million in convertible bonds. While a portion of the funds will be used to repay the M$100 million Islamic loan, we believe that the remainder will be used as working capital for the ME projects. The dilution arising from the issue of ICPS and convertible bonds has been accounted for in our RNAV.

Valuation and rating analysis

We are initiating coverage on WCT Engineering with an Overweight rating and a December-2008 PT of M$6.40, implying a potential 16% upside. Our key assumptions for the SOP are:

- Construction earnings are pegged at 15x forward P/E, in line with the long-term industry average;
- Property earnings are pegged at 12x forward P/E, in line with the long-term industry average;
- AEON shopping lease is a “10+5+5+5 years” deal, and management has guided for a net rental yield of 7%. We have also imputed a 5% p.a. rental growth, renewable according to the lease terms;
- For the purpose of computing the fully diluted shareholding, all ESOS have been converted at an average strike price of M$3.00 per share, while convertible bonds have been converted at the current market price.

Table 6: WCT—Sum-of-the-parts valuation

	Parameter	FY08E NP	Value (M$ MM)	Remarks
Construction	P/E 15x	97.78	1466.7	<== In line with long-term industry average
67% WCT Land (Ticker: WCTL MK)	Marked-to-market	51.65	380.7	<== M$1.68 per share (22-Aug-07)
Other divisions	P/E 8x	7.71	61.7	
Concessions*	DCF at 10% WACC	11.99	296.7	
AEON shopping lease**	DCF at 8% WACC	0.00	269.4	
Net debt			-355.23	<== As of FY07E
Existing share base			302.23	
RNAV per share (on existing share base)			M$7.10	
Cash from unexercised ESOS			18.00	<== Assuming M$3 per share strike price
Cash from ICPS			151.11	
Debt offset from CB			262.50	<== US$75 million issuance
Interest savings from immediate CB conversion			13.13	<== 1% coupon, over 5 years
Dividend savings from immediate ICPS conversion			34.00	<== 4.5% dividends, over 5 years
Fully diluted share base			410.33	
RNAV per FD share			M$6.40	

Source: JPMorgan estimates.
* Concessions are made up of 3 tolled highways in India, and the higher cost of capital (10% WACC) reflects a geographic risk premium.
** The shopping mall lease is a contract with AEON Jusco for the mall in Bandar Bukit Tinggi. The lower cost of capital (8% WACC) reflects a lower cost of debt due to local financing.

SWOT analysis

Strengths

- **A Middle East proxy:** Having been involved in seven infrastructure projects in the ME, and with over 60% of its existing orderbook coming from that region, WCT has proven itself to be a pioneer Malaysian developer that has benefited tremendously from the surge in infrastructure spending in UAE, Qatar, and Bahrain.
- **High earnings visibility, strong growth:** To further supplement its existing orderbook of M$5 billion, WCT has tendered for over M$9 billion in construction projects, M$2 billion of which it deems to be realistic. The existing orderbook represents 5x the construction revenue booked in FY06, in line with its larger construction peers, such as IJM, Gamuda, and Zelan.
- **Strong execution, strong niches:** The strength of the company still lies in its execution, given its ability to maintain a low cost structure due to its subcontracting experience. WCT has also developed two special niches in infrastructure development over the past 10 years—airports and racetracks.

Weaknesses

- **Dilution from ICPS and convertible bonds:** The group has recently raised funds worth M$414 million—from a combination of M$155.1 million in irredeemable convertible preference shares (ICPS) and US$75 million in convertible bonds.
- **Net gearing to rise:** With the onset of the US$75 million convertible bond issue, which is slated for completion by 4Q CY07, we expect net gearing to increase sharply from its current 37% to 48%. Despite the sharp rise, this is still significantly below its internal limit of 100%, thus implying more room for further debt issues. Furthermore, we expect net gearing to steadily decrease to below about 30% as working capital requirements stabilize beyond FY09.

Opportunities

- **Potential take-over target?** We see WCT as a possible takeover target, as Malaysian contractors scramble for a stronger balance sheet to pitch for larger-scale projects in the ME. Valuations are still relatively attractive, and management is friendly with the larger contractors such as Gamuda (both parties are currently collaborating in the ME).
- **Vietnam could be a pleasant surprise:** WCT is following in the footsteps of other Malaysian companies, such as Gamuda and SP Setia, and we are excited by this venture given the property boom cycle in Vietnam. Early indications point to a mix of commercial development and high-rise condominiums, with GDV being in excess of M$1.5 billion. Margins for property developments in Vietnam tend to hover around 30%, and this more than compensates for the execution risk faced by the developers.

Threats

- **Property glut in FY08:** While a significant portion of WCT's launches will be targeted for 2008, we highlight a potential risk of a property glut in the Klang Valley region depressing sales.
- **Margin pressure from local projects:** Building materials inflation in Malaysia is likely to continue to apply downward pressure on construction margins and property development costs. We are mindful of further inflation arising from cement and steel bars as a key threat.
- **Middle East execution:** While most Malaysian contractors have ventured aggressively into the ME over the past five years (as a move to grow independent of the Malaysian construction cycle), project execution has been very difficult for most. Cost overruns are severely punished for ME projects due to the strict contractual terms on penalties, and the sourcing of building materials can be very expensive if not hedged correctly.

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WCT Engineering: Summary of financials

Profit and Loss statement				
M$ in millions, year-end Dec	FY06A	FY07E	FY08E	FY09E
Revenues	1,400.4	1,663.7	2,414.1	2,777.0
% change Y/Y	69.7%	18.8%	45.1%	15.0%
Gross Margin (%)	15.1%	14.8%	16.9%	17.1%
EBITDA	220.2	249.4	385.7	442.0
% change Y/Y	58.2%	13.2%	54.7%	14.6%
EBITDA Margin (%)	15.7%	15.0%	16.0%	15.9%
EBIT	172.9	196.7	326.3	376.1
% change Y/Y	28.8%	13.8%	65.9%	15.3%
EBIT Margin (%)	12.3%	11.8%	13.5%	13.5%
Net Interest	(27.3)	(32.9)	(45.4)	(49.7)
Earnings before tax	149.8	171.6	290.1	337.3
% change Y/Y	15.9%	14.5%	69.1%	16.3%
ICPS Dividends	-	(7.0)	(7.0)	(7.0)
Tax	(34.6)	(46.3)	(75.4)	(87.7)
Net Income (Core)	88.1	98.1	169.1	192.6
% change Y/Y	7.6%	11.4%	72.3%	13.9%
Avg. Shares Outstanding	213.2	257.7	302.2	302.2
EPS (Reported) (sen)	41.3	38.1	56.0	63.7
% change Y/Y	2.1%	-7.8%	47.0%	13.9%

Cash flow statement				
M$ in millions, year-end Dec	FY06A	FY07E	FY08E	FY09E
EBIT	172.9	196.7	326.3	376.1
Depreciation & amortisation	47.3	52.7	59.4	65.8
Change in working capital	-17.0	-121.3	-137.5	-153.5
Taxes	-33.2	-12.0	-20.3	-23.6
Cash flow from operations	188.2	68.4	169.8	205.1
Capex	-270.5	-120.0	-150.0	-150.0
Disposal/ (purchase)	-70.5	-70.5	-70.5	-70.5
Net Interest	-27.3	-32.9	-45.4	-49.7
Free cash flow	-82.3	-51.6	19.8	55.1
Equity raised/ (repaid)	3.7	33.0	0.0	0.0
Debt raised/ (repaid)	177.5	317.6	200.0	200.0
Other	0.0	0.0	0.0	0.0
Dividends paid	-23.0	-45.3	-45.3	-45.3
Net Change in Cash	-42.0	183.1	104.0	139.2
Beginning cash	408.6	411.6	594.7	698.7
Ending cash	411.6	594.7	698.7	837.9
Gross DPS - M$	0.15	0.15	0.15	0.15

Balance sheet				
M$ in millions, year-end Dec	FY06A	FY07E	FY08E	FY09E
Cash and cash equivalents	411.6	594.7	698.7	837.9
Accounts receivable	625.9	743.6	1,079.0	1,241.2
Inventories	0.6	0.8	1.1	1.3
Others	451.9	708.0	921.6	1,050.7
Current assets	1,490.1	2,047.0	2,700.3	3,131.0
LT investments	140.2	140.2	140.2	140.2
Total fixed assets	635.8	723.7	834.8	939.5
Total assets	2,266.1	2,910.9	3,675.3	4,210.7
Liabilities				
ST loans	276.2	276.2	376.2	476.2
Payables	429.3	511.6	723.8	831.1
Others	415.1	492.8	693.2	794.6
Total current liabilities	1,120.5	1,280.6	1,793.3	2,101.9
Long term debt	356.1	673.7	673.7	673.7
Other liabilities	33.4	34.7	34.7	34.7
Total liabilities	1,510.0	1,989.0	2,501.7	2,810.3
Shareholders' equity	593.1	733.6	857.4	1,004.7
BVPS - M$	2.8	2.8	2.8	3.3

Ratio Analysis				
M$ in millions, year-end Dec	FY06A	FY07E	FY08E	FY09E
Pretax margin	10.7%	10.3%	12.0%	12.1%
Operating margin	12.3%	11.8%	13.5%	13.5%
Net profit margin	6.3%	5.9%	7.0%	6.9%
Sales per share growth	61.1%	-1.7%	23.7%	15.0%
Sales growth	69.7%	18.8%	45.1%	15.0%
Net profit growth	7.6%	11.4%	72.3%	13.9%
EPS growth	2.1%	-7.8%	47.0%	13.9%
Interest coverage (x)	8.05	7.59	8.49	8.89
Net debt to total capital (x)	0.10	0.12	0.10	0.07
Net debt to equity (x)	0.37	0.48	0.41	0.31
Sales/assets (x)	0.62	0.57	0.66	0.66
Assets/equity (x)	3.82	3.97	4.29	4.19
ROE	15%	13%	20%	19%
ROCE	14%	12%	17%	17%

Source: Company data, JPMorgan estimates.