

# OSK

## MALAYSIA EQUITY Investment Research Daily News

### CONSTRUCTION

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#### Stock Profile/Statistics

Bloomberg Ticker	
KLCI	
Issued Share Capital (m)	120.00
Market Capitalisation (RMm)	198.00
52 week H   L Price (RM)	1.78   1.18
Average Volume (3m) '000	366.92
YTD Returns (%)	N.A.
Net gearing (x)	-0.12
Altman Z-Score	N.A.
ROCE/WACC	N.A.
Beta (x)	N.A.
Book Value/share (RM)	0.97

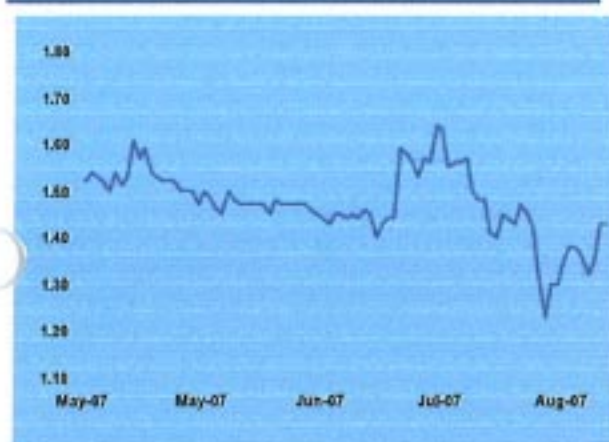
#### Major Shareholders (%)

Alpine Equity (M) SB	23.6%
Melati Corp SB	20.9%
Desalink SB	11.6%

#### Share Performance (%)

Month	Absolute	Relative
1m	18.88	13.81
3m	13.33	6.36
6m	11.84	2.71
12m	N.A.	N.A.

#### 6-month Share Price Performance



### Initiating Coverage

Private Circulation Only

## Melati Ehsan

BUY  
Price  
Target

Initiate  
RM1.65  
RM2.48

### To Grow In Stature

Melati remains an undiscovered gem in the construction sector, in our view. Underpin by its strong orderbook of RM1.4bn, we can expect more to come as the company would "create" projects for itself rather than wait. Given the positive outlook, we initiate coverage on the stock with a BUY with target price at RM2.48, citing a 50% upside.

**The player.** Melati was listed on the main board of Bursa Malaysia in March 2007. Being the only main board construction stock listed in the past 3 years, we believe this latest addition have much to offer investors. The company is mainly involved in turnkey construction with a specialisation in construction management.

**Order book.** Melati's outstanding order book currently stands at some RM1.4bn. Our estimates indicate that this makes up 8.4x and 4.5x FY07 and FY08 revenue respectively and sufficient to sustain earnings over the next 3 years. We are confident that the company will be able to replenish its order book by RM400m p.a. From 04 to 07, the company's order book grew at a 38.5% CAGR, reinforcing our view.

**Getting a slice of the 9MP pie.** The company has tendered for some RM1.7bn worth of jobs, of which >80% falls under the 9MP. Of particular interest, is the flood mitigation scheme to be launched. Melati is currently involved in a flood mitigation project up north. Management has indicated to us that its historical success rate has stayed above 30%.

**Creating opportunity.** We like Melati's ability to identify certain inherent problems in existing structures and subsequently, proposing solutions to its potential clients. In essence, Melati "creates" projects for itself rather than wait for available jobs. Jobs attained and completed thus far via this method sum up to some RM300m.

**Venturing into property development.** Melati recently acquired some 99.3 acres of land in Pandamaran, Klang for RM32m. The mixed development is estimated to have a GDV of RM500m and should begin construction soon with a target completion by end 2012.

**Initiate with a BUY.** Our forecasts show a 22% and 30% y-o-y growth in Melati's earnings for FY08 and FY09. By tagging FY08 earnings to a 9x multiple, we derive a target price of RM2.48. Melati is currently trading at 6.0x and 4.6x FY08 and FY09 earnings, or a steep discount to the average 10x to 13x multiples of small cap construction players. With a 50% upside, we initiate coverage on Melati with a BUY.

FYE Aug (RMm)	FY05	FY06	FY07	FY08f	FY09f
Turnover	133.3	144.2	173.4	322.3	420.7
EBITDA	23.1	31.8	35.4	45.8	58.8
Net Profit	16.2	22.7	27.1	33.1	43.0
% chg YoY	11.8%	40.1%	19.6%	21.9%	30.1%
Consensus					
EPS (sen)	13.5	18.9	22.6	27.5	35.8
DPS (sen) <sup>^</sup>	-	13.8	7.5	6.9	10.8
Div Yield <sup>^</sup>	0.0%	8.3%	4.5%	4.1%	6.5%
ROE	39.1%	42.0%	31.3%	22.8%	22.8%
ROA	16.3%	17.6%	18.2%	13.2%	12.6%
PER (x)	12.3	8.8	7.3	6.0	4.6
P/BV (x)	3.9	3.5	1.7	1.1	1.0

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See important disclosures at the end of this publication



## KEY HIGHLIGHTS

### BACKGROUND

**New kid on the block.** Melati Ehsan Bhd (Melati) was listed on the main board of Bursa Malaysia in March 2007. The company is mainly involved in turnkey construction with a specialisation in construction management. It is also into property development and trading. Via its subsidiaries, Melati is ranked as both a Class A and Class G7 contractor. This enables the company to bid and construct an unlimited amount worth of projects. Figure 1 below depicts Melati's current corporate structure.

Figure 1: Melati's corporate structure



Source: Company

**Turnkey is key.** Unlike a general contractor who merely constructs based on the given design, a turnkey contractor participates with the architect and engineering consultants from the initial project design stage. This enables the turnkey contractor to provide his knowledge at the initiation of the project and identify the potential problems that may emerge prior to the construction commencement. Overall, the key result of such an approach is cost savings, enhanced efficiency and speedier completion time.

**Construction management in perspective.** Construction management involves a holistic process of planning, design and construction of a project from its inception to completion. Usually, the construction manager is also the project's main contractor. While this is so, Melati does engage other sub contractors for works that are labour and capital intensive. Using such an "asset light" approach, Melati is able to maintain minimal investments in construction machineries and plants. Further, Melati's labour contributions to the construction process mainly constitute knowledge workers, removing it of problems associated with foreign labour employment.

**Track record.** As of FY07, Melati has completed a total of some RM290m worth of projects. Whilst appearing rather small at first glance, we believe this figure is set to grow in the coming years given the size of its outstanding order book (discussed next). Its completed projects include property construction works such as apartments, shop lots and houses. Melati has also completed some RM139m worth of road works. Details of its completed projects are displayed in the Appendix.

**Dedicated management.** Melati is headed under the leadership of its founder Dato' Yap Suan Chee, who is also its managing director. Dato' Yap has over 20 years of experience in the construction and property development and was involved in the construction of the French Embassy in Kuala Lumpur. Another key management of the group is Ir Tan Hong Hing, who is Melati's executive director. Mr. Tan is a professional engineer registered with the Board of Engineers of Malaysia and has been in the industry for more than 20 years. Subsequent to our meeting with the fellow gentlemen, our take is that, the management of Melati are indeed (i) focused in driving growth for the group, (ii) conservative in their guidance towards the investment community and (iii) able to identify and execute profitable opportunities.

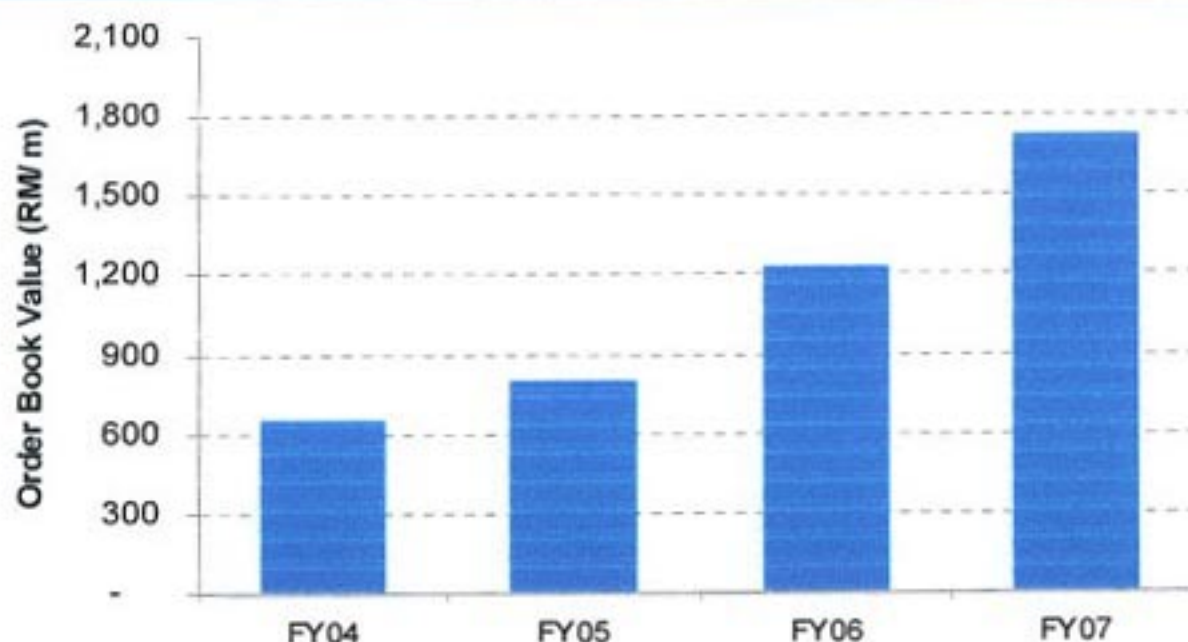


## INVESTMENT MERITS

**Backed by a solid order book.** Melati's order book currently stands at some RM1.7bn. With 85% of it still outstanding, we feel that Melati is in the verge of displaying a strong growth moving forward. Our calculations indicate that its outstanding order book is 8.4x and 4.6x FY07 and FY08 revenue respectively. We also estimate that its unbilled amount should be able to keep the company busy for the next 3 years, as that is the average project lifespan outstanding.

**Replenishment rate should remain strong.** We believe Melati is capable of replenishing its order book by some RM400m annually. In our view, this should be sufficient to maintain its outstanding order book amount given our FY08 and FY09 annual burn rate of between RM300m and RM420m. Between FY04 and FY07, the company managed to grow its order book at a 38.5% CAGR. From our understanding, Melati has tendered for projects with a total value exceeding RM1.7bn. Management indicated to us that its historical success rate has always stayed above the 30% mark.

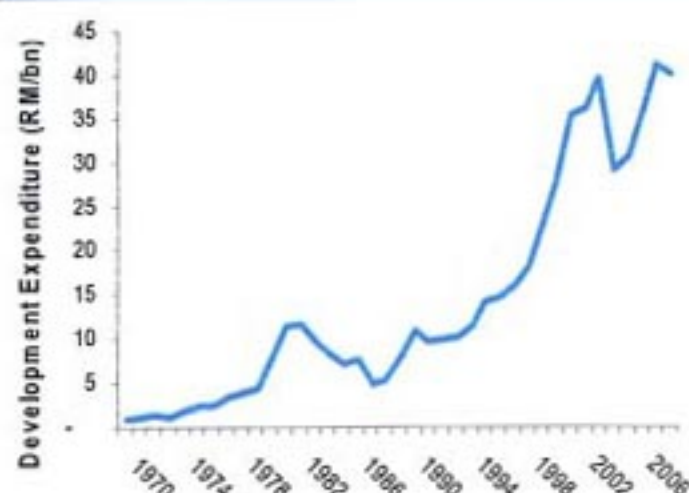
Figure 2: Growing its order book at a CAGR of 38.5%



Source: Company

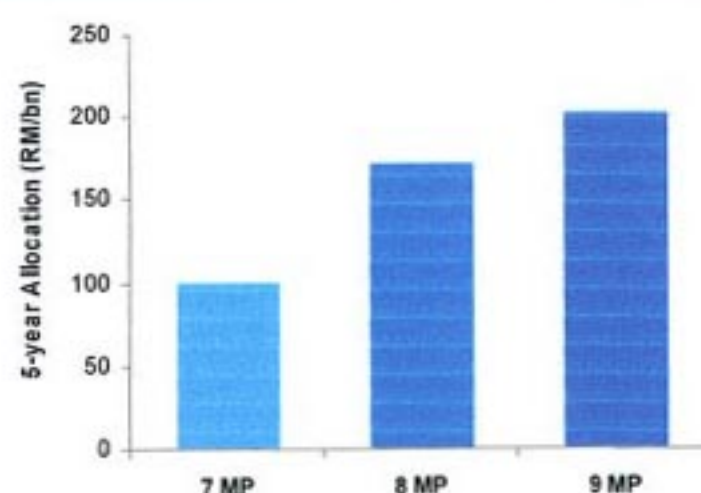
**Poised to get some.** With some RM200bn being allocated under the 9MP, we are confident that Melati will emerge as one of the beneficiaries. Approximately 80% of its tendered projects are under the 9MP. While government development expenditure is expected to remain flattish y-o-y at RM40bn for 2008, we believe that the company will continue to secure more government projects due to its track record. As it is, Melati has received recurring projects from government bodies such as Jabatan Kerja Raya (JKR) and Perbadanan Kemajuan Negeri Selangor (PKNS).

Figure 3: Gross development expenditure



Source: Bank Negara Malaysia

Figure 4: Allocation for the Malaysia Plans



Source: Bank Negara Malaysia



**Which slice of the pie?** It is our opinion, Melati could potentially secure some jobs in both the north and south of Peninsular Malaysia given its track record there. In 2005, Melati completed a 7 span bridge crossing the Muda River, Penang on a fast track basis in less than 4 months. Upon completion, the company received an Award of Excellence for its works by JKR. Its exposure in Johor includes pilling and building works, earthworks and retaining walls for terrace houses, monsoon drainage and a TNB substation. It was also involved in the construction of a sewerage treatment plant there.

**Figure 5: A completed bridge in < 4 months**



Source: Company

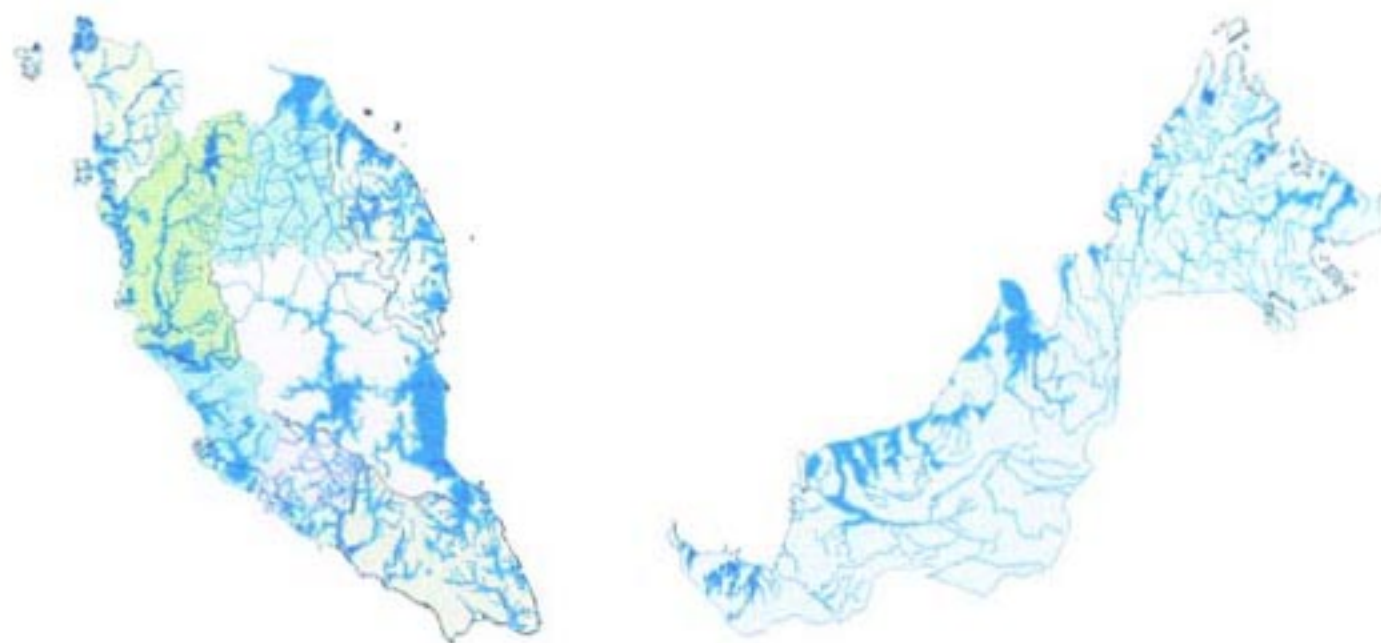
**Figure 6: Some of Melati's works in Johor**



Source: Company

**Adversity to opportunity.** Whilst many would be inclined to avoid flood prone areas, we believe that the opposite is true for Melati. The Star recently reported "A major scheme costing RM200m to tackle flood woes is expected to be ready by the end of the year...The plan comprises 40 projects including repairing bridges and widening river banks...The government would also implement middle term and long term plans to overcome flood problems in several areas..." It was also stated that the middle term plans would cost RM840m and the longer term plans at RM6bn. We hypothesise that Melati could emerge as a player in this niche area as it is already conducting flood mitigation works in Kepala Batas, Penang. Figure 7 below shows the various flood prone areas in Peninsular Malaysia.

**Figure 7: Flood prone areas in Malaysia**



Note: Light blue shades indicate flood prone areas

Source: [www.klikinfo.com](http://www.klikinfo.com)

**Construction's go getter.** Another reason why we like Melati is the management's ability to identify problems inherent in current structures and suggest solutions to potential clients. Via this method, Melati effectively "creates" projects for its potential clients rather than wait for jobs. To illustrate, the company identified traffic flow problems getting into the Free Trade Zone in Pusat Bandar Seport as there was only a single entrance via the LDP highway. The company then submitted a proposal to JKR to construct a second entrance to the zone via the Federal Highway. That proposal earned them an RM53m project to construct the Majlis Link (Figure 7). Melati also used its "identify and innovate" method to clinch the upgrading works done (to resolve traffic conjection) at FR54, Sg. Buloh, Selangor (Figure 8).



**Figure 8: The upgraded FR54 in Sq. Buloh**



Source: Company

**Figure 9: Melati's property development – Taman Ehsan Jaya in Pandamaran, Klang**



Source: Company

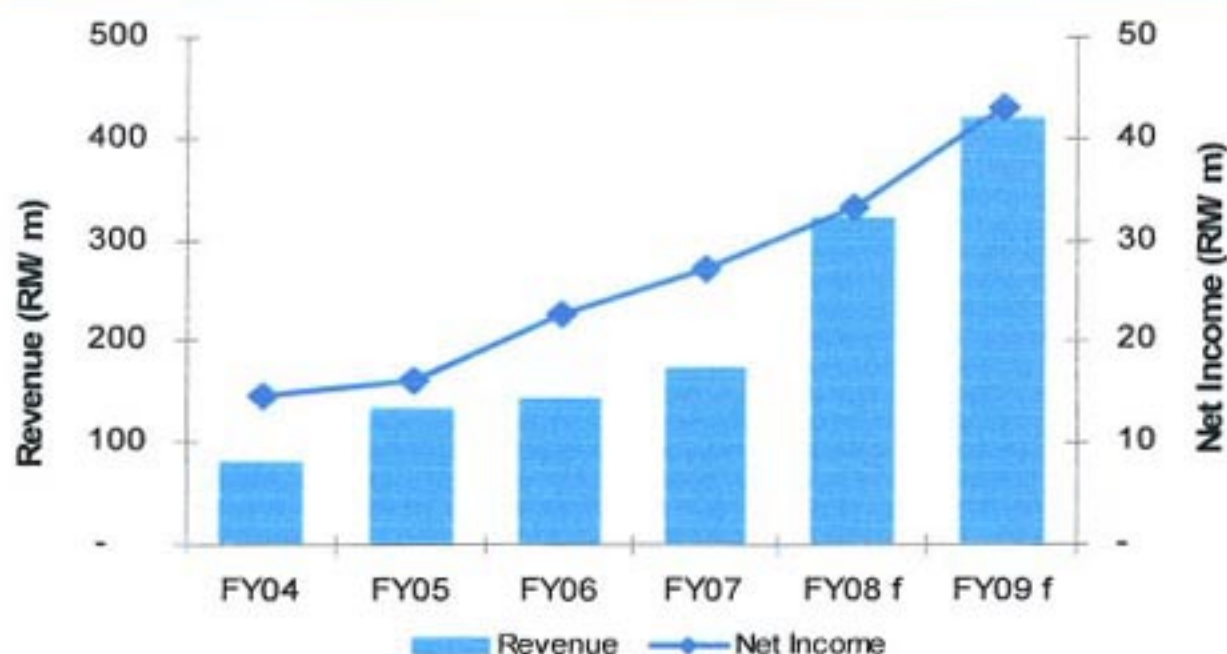
**No immediate impact just yet.** Management has indicated that construction will begin anytime soon and has set a target launch somewhere around 1Q 2008. Completion of the entire development is scheduled by Nov 2012. For the sake of conservatism, we have imputed a very minimal impact from the property development to our FY08 and FY09 numbers. Our gross margin estimates for the property division range between 48% and 50%. We expect some meaningful contribution from this division commencing FY10 but do note that positive surprises (better than expected take up rates) are not out of reach. While some may be concerned that Melati's latest cash balance is RM37m against the land purchase price of RM32m, management has alluded to us that payments would be staggered over 3 years.



**Partially hedged.** All of Melati's government contracts hold a Variation of Price (VOP) clause allowing it to claim the difference in price should there be any increment in raw material cost. As such, margins for its government projects are almost fully locked in. From our calculations, government projects (mainly from JPS and JKR) make up 26% of its outstanding order book.

**Financial talk.** Driven by its strong order book, we forecast a revenue of RM322m (86% y-o-y) and RM421m (31% y-o-y) respectively for FY08 and FY09. However, we predict an overall margin erosion will occur following the commencement of some of its lower margin projects. Having said that, our estimates show that Melati's gross margins of between 15% and 16% are indeed higher than most construction players (avg. 7%-10%). All in all, we forecast that earnings will grow by 22% for FY08 and 30% for FY09.

**Figure 10: Growing topline and bottomline**



Source: Company

**Is it debt?** Looking back at Melati's balance sheet, we noticed that its long term debt had increased from virtually nil to RM19.3m. Based on our discussion with management, the debt was essentially a method at which they received cash for government projects. Rather than receiving cash outright from the government when payments are due, the government has requested that Melati take a loan of the equivalent amount from Bank Pembangunan. After a certain time frame, the government would repay the bank for the equivalent sum along with interest charges. The loan is guaranteed by the government. Looking at it from such a perspective, with the exception of some insignificant short term debt, Melati is actually "debt free".

**Clearly an undervalued gem.** At current price, Melati is trading at an undemanding 6.0x and 4.6x FY08 and FY09 earnings. This represents a steep discount to the average forward multiples of small cap construction players. By tagging FY08 EPS to a multiple of 9x, we derive our target price of RM2.48. While our multiple tagged may be lower than other small cap players of between 10x and 13x, we believe this is justifiable given the company's recently listed status. However, we do not rule out a re rating possibility.

Given the sanguine prospects, coupled with an upside of 50%, we initiate coverage on the stock with a BUY call.

FYE Aug (RMm)	FY05	FY06	FY07	FY08f	FY09f
Turnover	133.3	144.2	173.4	322.3	420.7
EBITDA	23.1	31.8	35.4	45.8	58.8
PBT	22.9	31.6	36.6	44.7	57.3
Net Profit	16.2	22.7	27.1	33.1	43.0
EPS (sen)	13.5	18.9	22.6	27.5	35.8
DPS (sen)	-	13.8	7.5	6.9	10.8
Margin					
EBITDA	17.3%	22.1%	20.4%	14.2%	14.0%
PBT	17.1%	21.9%	21.1%	13.9%	13.6%
Net Profit	12.1%	15.7%	15.6%	10.3%	10.2%
ROE	39.1%	42.0%	31.3%	22.8%	22.8%
ROA	16.3%	17.6%	18.2%	13.2%	12.6%
Balance Sheet					
Fixed Assets	0.9	1.0	22.1	32.5	36.6
Current Assets	154.9	99.6	174.0	270.8	340.4
Total Assets	155.9	101.1	196.6	303.8	377.6
Current Liabilities	105.0	44.0	60.8	106.2	144.9
Net Current Assets	50.0	55.7	113.2	164.6	195.6
LT Liabilities	0.0	0.1	19.3	24.3	29.3
Shareholders Funds	50.9	57.1	116.5	173.3	203.4



## APPENDIX

Table 1: Melati's track record

Project Description	Location	Client	Value
Turnkey construction of 334 double story terrace houses and 34 semi detached houses.	Kota Damansara	PKNS	106.3
Turnkey project to upgrade FR54 (roadworks)	Sungai Buloh	JKR	86.3
Turnkey project for building a link road at Free Trade Zone Pusat Bandar Seaport.	Damansara Jaya	JKR	52.7
Building works for terrace houses, moonsoon drainage and TNB substation. Civil and structure, mechanical and electrical works for sewerage treatment plant.	Plentong, Johor	TPPT SB	19.2
Construction of low cost appartments, low cost shops and sewerage treatment plant.	Rawang	Selayang Council	15.0
Construction of a 7 span bridge	Penang	JKR	10.3
<b>Total Value</b>			<b>289.8</b>

Source: Company

Table 2: Melati's order book outstanding

Project Description	Location	Client	Unbilled	Completion
Turnkey construction - Bayu Perdana (Phase 1)	Kota D'sara	PKNS	0.7	Dec-07
Flood mitigation project	Kepala Batas	JPS	147.8	Feb-09
Mixed development projects	Bernam Jaya	PKNS	55.0	Aug-14
Highway project - Trans Eastern Kedah Interland	Kedah	JKR	231.7	Aug-08
Turnkey construction -Taman Aman Putra	Kuala Lumpur	DBKL/MLSB	424.5	Oct-10
Construction - Infrastructure works	Johor	TPPT/ MEDSB	1.4	Nov-07
Construction - 281 units double story terrace houses, TNB substation	Johor	TPPT/ MEDSB	4.1	Apr-08
Turnkey construction - Bauy Perdana Phase 2 and Phase 3	Kota D'sara	PKNS/ Bonus Focus SB	30.3	Apr-09
Construction - 113 units double story terrace houses and 64 units low/ mid cost shoplots	Johor	TPPT/ MEDSB	5.2	Dec-07
Construction - Infrastructure works 2	Johor	TPPT/ MEDSB	3.1	Apr-08
Construction - 4 blocks of 3 storey appartements	Johor	TPPT/ MEDSB	8.5	Nov-08
Mixed development comprising 501 residential houses and 320 shop lots	Klang	TPPT	500.0	Nov-12
Construction of Carrefour	Kota D'sara	Magnificent Diagraph SB	50.0	Aug-08
<b>Total</b>			<b>1,462.3</b>	

Source: Company



**OSK Research Guide to Investment Ratings****Buy:** Share price may exceed 10% over the next 12 months**Trading Buy:** Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain**Neutral:** Share price may fall within the range of +/- 10% over the next 12 months**Take Profit:** Target price has been attained. Look to accumulate at lower levels**Sell:** Share price may fall by more than 10% over the next 12 months**Not Rated:** Stock is not within regular research coverage

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