

Hock Seng Lee (HSL MK)

Intention to privatize

Unconditional voluntary cash offer of MYR1.35/sh

The unconditional voluntary take-over offer for the remaining 87m shares (15.81%) in HSL for MYR1.35/shr by Hock Seng Lee Enterprise Sdn Bhd (HSL E) is 39% above our previous TP of MYR0.97, but in-line with its current share price. We believe the offer price is fair, which implies 15x FY22E PER and 0.8x P/BV (5-year mean). HSL's net cash was MYR213m end-Sep 2021. We lift our TP to reflect the offer price; maintain HOLD.

No intention to maintain listing status

To-date, HSL E and its joint offerors hold an aggregate 84.19% of total shares. As a result, HSL's public shareholding spread has fallen below 25% since 30 Dec 2021. We understand that, HSL E does not intend to maintain HSL's listing status, upon receiving acceptance for its take-over offer which would bring its holding to above 90%.

Offer price is fair

The offer price of MYR1.35 is 0.7% above yesterday's closing share price. We do think that the offer price is fair being 39% above our previous TP of MYR0.97 which was based on 11x FY22E PER. At MYR1.35, HSL is valued at 15.3x FY22E PER, about its 5-year historical mean of 15.8x.

Challenging near-term outlook

With no sizeable projects clinched in FY21, we estimate HSL's outstanding orderbook currently stands at MYR1.6b, providing earnings visibility until FY23. However, its near-term prospects remain challenging due to labour shortage, and high construction material and logistic costs. Elsewhere, its property projects have a gross development value of c.MYR2bn, with a development phase over 10-15 years.

| FYE Dec (MYR m) | FY19A | FY20A | FY21E | FY22E | FY23E |
|------------------------------|----------|----------|----------|----------|----------|
| Revenue | 684 | 538 | 568 | 648 | 735 |
| EBITDA | 86 | 53 | 60 | 72 | 80 |
| Core net profit | 55 | 33 | 39 | 49 | 54 |
| Core EPS (sen) | 10.0 | 6.0 | 7.1 | 8.8 | 9.8 |
| Core EPS growth (%) | 2.7 | (40.6) | 18.8 | 24.6 | 11.0 |
| Net DPS (sen) | 2.4 | 0.0 | 0.0 | 2.1 | 2.4 |
| Core P/E (x) | 13.2 | 16.8 | 18.9 | 15.2 | 13.7 |
| P/BV (x) | 0.9 | 0.7 | 0.8 | 0.8 | 0.8 |
| Net dividend yield (%) | 1.8 | 0.0 | 0.0 | 1.6 | 1.8 |
| ROAE (%) | 6.9 | 3.9 | 4.5 | 5.4 | 5.7 |
| ROAA (%) | 4.9 | 2.8 | 3.2 | 3.8 | 4.1 |
| EV/EBITDA (x) | 7.6 | 6.5 | 8.6 | 7.2 | 6.6 |
| Net gearing (%) (incl perps) | net cash | net cash | net cash | net cash | net cash |
| Consensus net profit | - | - | 38 | 51 | 55 |
| MKE vs. Consensus (%) | - | - | 1.4 | (5.2) | (1.5) |

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HOLD

| | |
|-----------------------|----------------|
| Share Price | MYR 1.34 |
| 12m Price Target | MYR 1.35 (+5%) |
| Previous Price Target | MYR 0.97 |

Company Description

Hock Seng Lee is involved in marine and civil engineering, building construction and property development.

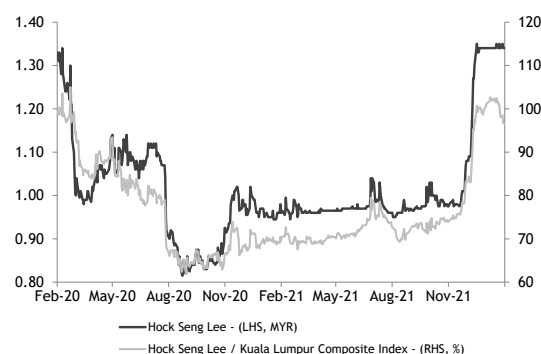
Statistics

| | |
|------------------------|----------------------|
| 52w high/low (MYR) | 1.35/0.95 |
| 3m avg turnover (USDm) | 0.1 |
| Free float (%) | 5.2 |
| Issued shares (m) | 583 |
| Market capitalisation | MYR780.8M USD186M |

Major shareholders:

| | |
|------------------------------------|-------|
| Hock Seng Lee Enterprise Sdn. Bhd. | 73.0% |
| Permodalan Nasional Bhd. | 12.9% |
| Hock Seng Lee Bhd. | 5.7% |

Price Performance



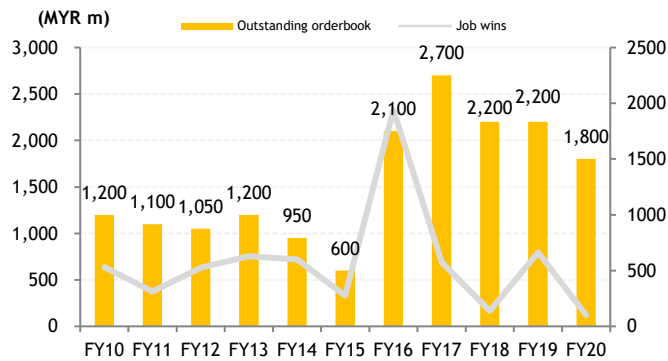
| | -1M | -3M | -12M |
|-----------------------|-----|-----|------|
| Absolute (%) | 0 | 37 | 40 |
| Relative to index (%) | (4) | 31 | 39 |

Source: FactSet

Value Proposition

- HSL is Sarawak’s market leader in marine engineering mainly due to its comprehensive fleet of equipment for marine-related infrastructure projects.
- HSL has also been involved in building construction, bridges, flyovers, airports, seaports, and road works.
- It is also engaged in property development for residential, commercial and industrial parks. Each of the development is about or >200 acres in size with long development roadmaps.

MYR1.8b outstanding order book as of end-FY20

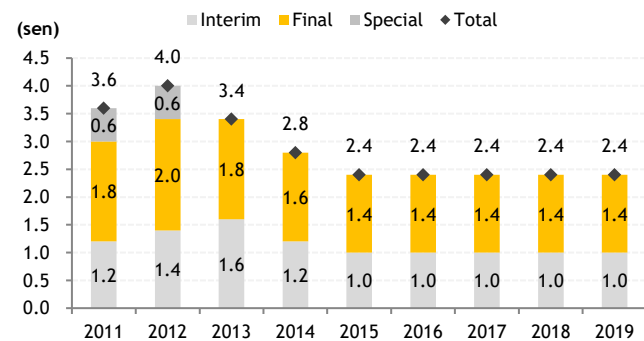


Source: Company

Financial Metrics

- Expect FY21E earnings to recover underpinned by its e.MYR1.8b outstanding orderbook end-FY20.
- In a net cash position of MYR205m as of end-FY20, with minimal borrowings.
- No dividend policy, but distributed consistent DPS of 2.4sen p.a. since FY15, except in FY20 as its operations were affected by COVID-led movement restrictions.

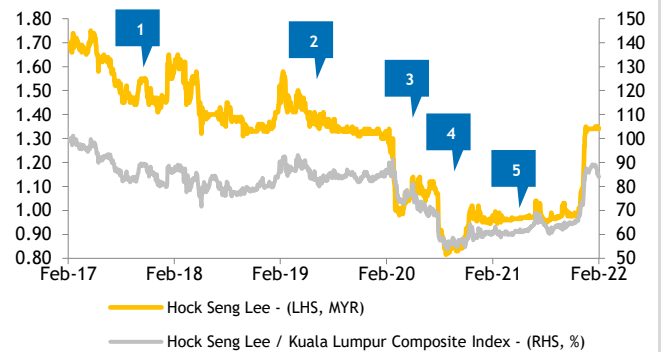
Dividend history



Source: Company

Price Drivers

Historical share price trend



Source: Company, Maybank IBG Research

1. The series of litigation matters involving HSL and the Yu/Yii family concludes (Sept 2017).
2. Secures a construction project to build the Batang Paloh bridge in Mukah (Apr 2019).
3. Implementation of Movement Control Order (18 Mar 2020).
4. Second wave of COVID-19 in Sarawak (Jul 2020).
5. First job win in FY21 from Yayasan Sarawak (Mar 2021).

Swing Factors

Upside

- Larger-than-expected orderbook replenishment could uplift its earnings.
- Increase in Government-led initiatives and infrastructure spending is favourable to the Group.
- Faster-than-expected vaccination programme will play a significant role in its performance outlook.

Downside

- Surges in COVID-19 cases in Sarawak could affect timing of earnings recognition.
- Labour shortages especially foreign workers could delay the progress of its construction projects.
- Unanticipated increase in construction material costs could adversely affect its financial performance.

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| | |
|----------------------------------|-----------|
| Risk Rating & Score ¹ | Not Rated |
| Score Momentum ² | na |
| Last Updated | na |
| Controversy Score ³ | na |

Business Model & Industry Issues

- As a market leader in marine engineering, its projects mostly address the “E” issues i.e. centralised sewerage systems in Kuching and Miri, flood mitigation works, embankments, revetments and seawalls. HSL regularly monitors its construction projects to mitigate their environmental impact relating to waste management, energy consumption, etc.
- HSL regularly conducts site inspections to ensure that they are compliant with CIDB Green Card requirements and it has valid work permits for foreign labour under its sub-contractors. HSL also has built its own quarantine centre to cater for the entry of new foreign workers once the border reopens.
- In our view, HSL is setting itself in the best position to manage ESG issues. We believe investors will better appreciate if HSL could provide additional disclosures and long-term targets to improve the ESG factors.

Material E issues

- Compliance on environmental protection is regularly itemised for review at project meetings.
- HSL’s new HQ office that is connected to *La Promenade Mall* is Sarawak’s first privately built building and mall designed for Green Building Index certification
- HSL encourages its staff and public to recycle waste materials by organising frequent ‘*Green Week*’ and providing a recycling centre within its HQ building, which is shared with the public.
- The group provides water saving sanitary and tapware in its property projects to reduce water consumption.
- HSL continuously manages and reduces construction materials on site. It uses water spray and water trucks to manage dust control on site, and monitors the maintenance of vehicles and equipment to avoid air pollution.
- HSL utilises approved sand sources and/or earth fill to avoid land contamination or degradation.

Material S issues

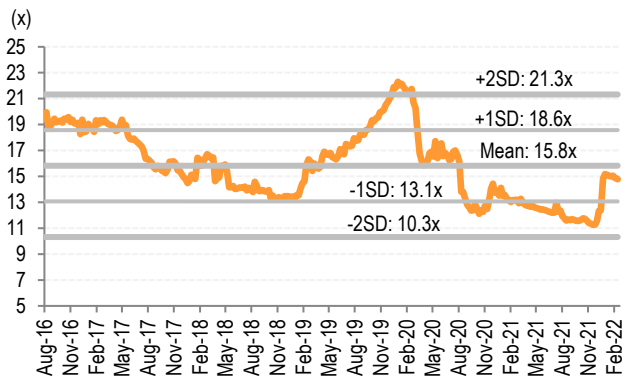
- In FY20, staff gender comprised 85% male and 15% female of the total 1,200 staff members; they are diversified in age (<35yo: 48%, 35-60yo: 44%, >60yo: 8%). Foreign workers made up 17% of its workforce.
- HSL reported 5 property damage incidents in FY20, compared to 10 in FY19, which relate to materials disturbed during excavations or heavy machinery operations. Measures to mitigate such incidents include utilities detection, pilot trenching, awareness training and toolbox briefings.
- Majority of HSL’s contracts are won under the open tender process. All sub-contract and supplier awards also go through rigorous competitive processes.
- HSL regularly conduct site inspection to ensure compliance with CIDB Green Card requirements and any foreign labour used by its sub-contractors have valid work permits. HSL has built its own quarantine centre to cater for the entry of new foreign workers once the border reopens.

Key G metrics and issues

- The Board comprises 9 members - 3 Executive Directors and 6 Non-Executive. Independent Directors are fairly well represented at 44% of the Board (4/9).
- Only 1 of the 9 Board members is a woman.
- Its largest shareholder, i.e. Hock Seng Lee Enterprise Sdn Bhd, is represented by 4 board members, while substantial shareholder i.e. Permodalan Nasional Berhad is represented by 1 board member; 4 remaining Independent Directors represent the interests of minority shareholders.
- The positions of Chairman of the Board and Managing Director (MD) are held by different individuals.
- Its Audit, Remuneration & Nomination Committees are chaired by Independent Non-Executive Directors.
- HSL provides detailed disclosure on remuneration of its directors but not of its top senior management (except its MD). In FY20, remuneration to directors was 7.7% of pre-tax profit. Its MD’s total remuneration package for FY20 was 3.5% of pre-tax profit (3y-avg: 2.9%).
- In FY20, KPMG PLT was the independent auditor for HSL. They have been appointed since 1995 (-26 years).
- HSL has adopted the Anti-Corruption and Bribery Policy in FY20.
- HSL has its Code of Ethics and Conduct in place, whereby it is committed to ethical business practices in all its operations. HSL has recurrent related party transactions (PRT) for the day-to-day operations of the Group involving rental of plant, machinery and vessels, purchase of raw materials and other-related construction services. This accounted for 24% of FY20’s revenue. HSL currently adopts a general policy to do all business lawfully, to ensure RPTs are being done on arm-length’s basis.

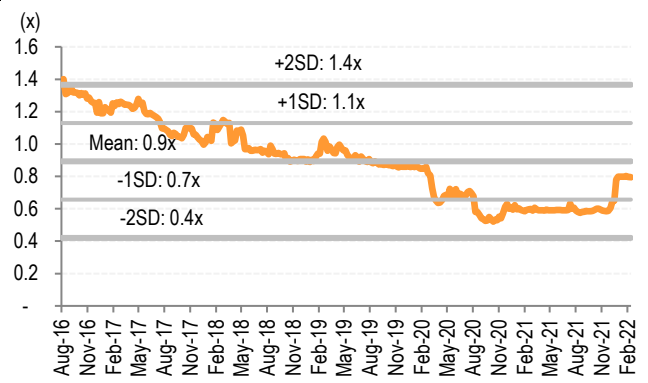
¹**Risk Rating & Score** - derived by Sustainalytics and assesses the company’s exposure to unmanaged ESG risks. Scores range between 0 - 50 in order of increasing severity with low/high scores & ratings representing negligible/significant risk to the company’s enterprise value, respectively, from ESG-driven financial impacts. ²**Score Momentum** - indicates changes to the company’s score since the last update - a **negative** integer indicates a company’s improving risk score; a **positive** integer indicates a deterioration. ³**Controversy Score** - reported periodically by Sustainalytics in the event of material ESG-related incident(s), with the impact severity scores of these events ranging from Category 0-5 (0 - no reports; 1 - negligible risks; ...; 5 - poses serious risks & indicative of potential structural deficiencies at the company).

Fig 1. 5-year forward PER



Source: Company, Maybank IBG Research

Fig 2. 5-year forward PB



Source: Company, Maybank IBG Research

| FYE 31 Dec | FY19A | FY20A | FY21E | FY22E | FY23E |
|-------------------------------------|----------------|----------------|----------------|----------------|----------------|
| Key Metrics | | | | | |
| P/E (reported) (x) | 13.8 | 17.6 | 18.9 | 15.2 | 13.7 |
| Core P/E (x) | 13.2 | 16.8 | 18.9 | 15.2 | 13.7 |
| P/BV (x) | 0.9 | 0.7 | 0.8 | 0.8 | 0.8 |
| P/NTA (x) | 0.9 | 0.7 | 0.8 | 0.8 | 0.8 |
| Net dividend yield (%) | 1.8 | 0.0 | 0.0 | 1.6 | 1.8 |
| FCF yield (%) | 10.3 | 26.8 | 3.1 | 1.6 | 1.6 |
| EV/EBITDA (x) | 7.6 | 6.5 | 8.6 | 7.2 | 6.6 |
| EV/EBIT (x) | 9.2 | 8.9 | 11.4 | 9.1 | 8.2 |
| INCOME STATEMENT (MYR m) | | | | | |
| Revenue | 683.6 | 538.3 | 568.2 | 648.2 | 734.7 |
| EBITDA | 86.3 | 53.5 | 60.0 | 72.4 | 80.2 |
| Depreciation | (15.5) | (14.4) | (14.7) | (14.9) | (15.3) |
| EBIT | 70.8 | 39.0 | 45.3 | 57.4 | 64.8 |
| Net interest income / (exp) | 3.3 | 4.4 | 6.6 | 7.3 | 7.0 |
| Associates & JV | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Exceptionals | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Pretax profit | 74.1 | 43.5 | 51.9 | 64.7 | 71.8 |
| Income tax | (18.8) | (10.7) | (13.0) | (16.2) | (18.0) |
| Minorities | (0.1) | (0.1) | 0.0 | 0.0 | 0.0 |
| Reported net profit | 55.2 | 32.8 | 38.9 | 48.5 | 53.9 |
| Core net profit | 55.2 | 32.8 | 38.9 | 48.5 | 53.9 |
| BALANCE SHEET (MYR m) | | | | | |
| Cash & Short Term Investments | 140.9 | 251.7 | 269.8 | 264.6 | 257.5 |
| Accounts receivable | 208.2 | 180.7 | 193.4 | 220.6 | 250.1 |
| Inventory | 160.2 | 146.2 | 152.6 | 173.0 | 196.7 |
| Property, Plant & Equip (net) | 216.4 | 214.3 | 218.8 | 225.0 | 233.5 |
| Intangible assets | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Investment in Associates & JVs | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other assets | 398.1 | 396.2 | 400.3 | 405.1 | 410.6 |
| Total assets | 1,123.8 | 1,189.2 | 1,234.9 | 1,288.2 | 1,348.4 |
| ST interest bearing debt | 13.7 | 14.7 | 14.7 | 14.7 | 14.7 |
| Accounts payable | 94.1 | 116.7 | 123.5 | 139.9 | 159.1 |
| LT interest bearing debt | 46.0 | 32.3 | 32.3 | 32.3 | 32.3 |
| Other liabilities | 149.0 | 180.0 | 180.0 | 180.0 | 180.0 |
| Total Liabilities | 302.5 | 343.5 | 350.3 | 366.8 | 386.0 |
| Shareholders Equity | 818.0 | 842.3 | 881.2 | 918.1 | 959.1 |
| Minority Interest | 3.3 | 3.3 | 3.3 | 3.3 | 3.3 |
| Total shareholder equity | 821.2 | 845.6 | 884.6 | 921.5 | 962.4 |
| Total liabilities and equity | 1,123.8 | 1,189.2 | 1,234.9 | 1,288.2 | 1,348.4 |
| CASH FLOW (MYR m) | | | | | |
| Pretax profit | 74.1 | 43.5 | 51.9 | 64.7 | 71.8 |
| Depreciation & amortisation | 15.5 | 14.4 | 14.7 | 14.9 | 15.3 |
| Adj net interest (income)/exp | 1.9 | 3.0 | 6.6 | 7.3 | 7.0 |
| Change in working capital | 16.9 | 112.6 | (12.2) | (31.1) | (34.0) |
| Cash taxes paid | (10.3) | (11.6) | (13.0) | (16.2) | (18.0) |
| Other operating cash flow | (0.0) | (3.1) | (6.6) | (7.3) | (7.0) |
| Cash flow from operations | 98.0 | 158.8 | 41.4 | 32.4 | 35.2 |
| Capex | (22.9) | (11.4) | (18.8) | (20.7) | (23.5) |
| Free cash flow | 75.2 | 147.4 | 22.7 | 11.6 | 11.7 |
| Dividends paid | (13.2) | (7.7) | 0.0 | (11.6) | (12.9) |
| Change in Debt | (34.5) | (12.7) | 0.0 | 0.0 | 0.0 |
| Other invest/financing cash flow | (29.2) | (16.0) | (4.5) | (5.2) | (5.9) |
| Net cash flow | (2.6) | 110.8 | 18.1 | (5.2) | (7.1) |

| FYE 31 Dec | FY19A | FY20A | FY21E | FY22E | FY23E |
|--|----------|----------|----------|----------|----------|
| Key Ratios | | | | | |
| Growth ratios (%) | | | | | |
| Revenue growth | 12.0 | (21.3) | 5.6 | 14.1 | 13.4 |
| EBITDA growth | 2.4 | (38.1) | 12.3 | 20.6 | 10.8 |
| EBIT growth | 1.4 | (44.9) | 16.1 | 26.8 | 12.9 |
| Pretax growth | 2.7 | (41.3) | 19.4 | 24.6 | 11.0 |
| Reported net profit growth | 2.7 | (40.6) | 18.8 | 24.6 | 11.0 |
| Core net profit growth | 2.7 | (40.6) | 18.8 | 24.6 | 11.0 |
| Profitability ratios (%) | | | | | |
| EBITDA margin | 12.6 | 9.9 | 10.6 | 11.2 | 10.9 |
| EBIT margin | 10.4 | 7.3 | 8.0 | 8.9 | 8.8 |
| Pretax profit margin | 10.8 | 8.1 | 9.1 | 10.0 | 9.8 |
| Payout ratio | 23.9 | 0.0 | 0.0 | 24.0 | 24.0 |
| DuPont analysis | | | | | |
| Net profit margin (%) | 8.1 | 6.1 | 6.9 | 7.5 | 7.3 |
| Revenue/Assets (x) | 0.6 | 0.5 | 0.5 | 0.5 | 0.5 |
| Assets/Equity (x) | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 |
| ROAE (%) | 6.9 | 3.9 | 4.5 | 5.4 | 5.7 |
| ROAA (%) | 4.9 | 2.8 | 3.2 | 3.8 | 4.1 |
| Liquidity & Efficiency | | | | | |
| Cash conversion cycle | 144.5 | 165.7 | 139.4 | 134.5 | 134.8 |
| Days receivable outstanding | 115.2 | 130.0 | 118.5 | 115.0 | 115.3 |
| Days inventory outstanding | 104.8 | 114.2 | 106.2 | 102.1 | 102.0 |
| Days payables outstanding | 75.6 | 78.5 | 85.4 | 82.6 | 82.5 |
| Dividend cover (x) | 4.2 | nm | nm | 4.2 | 4.2 |
| Current ratio (x) | 2.8 | 2.5 | 2.5 | 2.5 | 2.5 |
| Leverage & Expense Analysis | | | | | |
| Asset/Liability (x) | 3.7 | 3.5 | 3.5 | 3.5 | 3.5 |
| Net gearing (%) (incl perps) | net cash | net cash | net cash | net cash | net cash |
| Net gearing (%) (excl. perps) | net cash | net cash | net cash | net cash | net cash |
| Net interest cover (x) | na | na | na | na | na |
| Debt/EBITDA (x) | 0.7 | 0.9 | 0.8 | 0.6 | 0.6 |
| Capex/revenue (%) | 3.3 | 2.1 | 3.3 | 3.2 | 3.2 |
| Net debt/ (net cash) | (81.3) | (204.8) | (222.9) | (217.6) | (210.5) |

Source: Company; Maybank

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