Management's Discussion and Analysis

Introduction

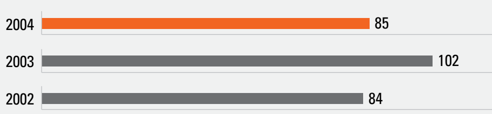
The GS and LG Groups have been split into independent entities to improve their specialization and secure separate business domains. This move also required that the name of the present company, a GS Group affiliate be changed to GS E&C Corporation. The GS Group is starting out anew by focusing on oil refining, construction, retail and other services. GS E&C is involved in the full range of engineering and construction areas, including civil engineering projects, environmental facilities, industrial plants, commercial buildings and apartment complexes.

Construction Market

The Construction Association of Korea reports that new contracts in the Korean construction market grew from ₩83 trillion in 2002 to ₩102.4 trillion in 2003. Since then, the economy has slumped and the real estate market has worsened, causing new contracts to fall 17% to ₩85 trillion in 2004. The figure for 2005 is forecasted to be about ₩84 trillion.

The Korean government previously announced a policy promising five million new housing units over ten years. In 2003, 585,000 new units were supplied nationwide, but the economic slowdown caused privately-financed building to contract, and only 464,000 units were supplied in 2004, a drop of 20.7% from the previous year.

New Contracts
(Unit : trillion of Won)



Source : Construction Association of Korea

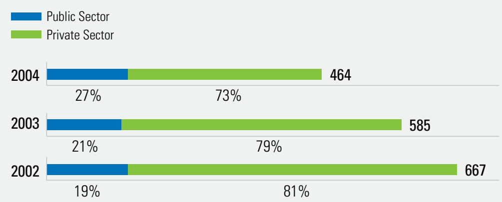
Breaking down the 2004 data, new public sector housing totaled 124,000 units, up 3.3% from the 120,000 units supplied in 2003. By contrast, the private sector built 340,000 units, 26.9% lower than the 465,000 units provided a year earlier. New apartment construction reached 405,000 units in 2004, up 12.6% from the 360,000 units averaged annually between 1999 and 2003. On the other hand, construction of non-apartment housing fell 49.5% from 116,000 units in 2003 to 59,000 units in 2004.

The Korean construction market can also be divided between the Greater Seoul Area (Seoul, Incheon and Gyeonggi Province) and all the other provinces. In 2003, the capital region gained 297,000 units, while housing in the provincial regions increased by 288,000 new units. The figures for 2004 were 206,000 for the Seoul vicinity (down 30.8%) and 258,000 (10.4% lower) for the rest of the country. The decline (49.8%) was most apparent in the capital region, from 116,000 units to 58,000 units.

The average housing price nationwide fell 2.1% in 2004 from the previous year, the sharpest price decline being for single-family homes(-3.6%) and low-rise townhouses (-5.5%) rather than high-rise apartments (-0.6%).

The gap between large residential builders and small and medium-sized enterprises continues to widen. Most of the large companies have increased their supply volumes. GS E&C supplied around 8,000 units in 2003 and 12,000 units in 2004, while plans call for doubling that figure to 14,000 units in the coming year.

Housing Construction by Sector
(Unit : thousands of Units)



Source : Construction Association of Korea

The government has been implementing measures to stabilize housing prices since late October 2003, causing the construction market to remain lackluster. A total of 57 areas around Korea were initially named as "real estate speculation and housing transaction notification zones," but some of those areas were subsequently de-listed in August and December 2004 as well as January 2005. Now the number of these intensely regulated zones stands at 31.

Public project bids are mainly awarded in one of three ways: turnkey, general eligibility, and lowest bidder. Currently the lowest bidder and turnkey methods are the most prevalent approaches. Price competitiveness is the most important factor for projects awarded to the lowest bidder, but recently the winning bids have fallen to around 50% of the government budget. Therefore, GS E&C rarely engages in these kinds of projects.

Winning turnkey bids requires not only a competitive price but also design expertise, financing capabilities, and skillful negotiation with rival companies to form a consortium. Now in Korea, private capital is being mobilized for infrastructure projects. PFI projects, which are steadily growing in number, require the abilities to uncover potential new projects, analyze project feasibility, provide financing, and operate the facilities once completed. Major Korean construction companies, GS E&C included, are increasingly involved in such endeavors.

Project Successes

GS E&C completed the 6th-generation LCD production facility (a total construction cost of ₩1 trillion) for LG Philips LCD in Korea success of this project paved the way for the company's receipt of an additional for a 7th-generation LCD plant.

Major overseas projects completed in 2004 include a ₩160 billion on-stream catalyst replacement plant for Kuwait National Petroleum Co. and a linear alkyl-benzene plant in Iran. The company received bonuses from both clients for finishing these projects ahead of schedule and for the outstanding performance of the completed facilities.

Growing Value for New Contracts

New orders have risen steadily in value in the past two years. New contracts in 2004 exceeded ₩6 trillion as opposed to the ₩5 trillion total received in 2003, and the Housing Business Division received the highest provisional order amount in the Korean housing sector for both 2003 and 2004, moving the company a step closer to its goal of securing the overall top market share by 2010.

Importantly, the company continues to pursue the more profitable turnkey projects instead of the lowest bid/general eligibility bid types. In 2003, eleven turnkey projects were awarded to GS E&C, and the company won thirteen such projects in 2004. Among these, the Architecture Business Division received contracts for five turnkey projects (worth ₩126 billion), and the Environment Business Division obtained four turnkey projects (worth ₩78 billion). Thus, the company has firmly demonstrated its competitiveness in these two sectors.

The 2005 target for new contracts has been set at ₩6.5 trillion. To achieve this goal, GS E&C will work to attract more turnkey/PFI projects as well as projects unrelated to affiliated companies. The company will also supply more housing units and aggressively pursue more plant and environmental facility projects.

New Overseas Markets, New Fields

GS E&C expanding its business scope in 2004, penetrating the Russia and Oman markets with large-scale plant projects. The company is also carrying out feasibility studies on development projects in Vietnam as part of an ongoing overseas market diversification effort.

Meanwhile, GS E&C continues to break into new project areas in order to achieve balanced operational growth. For example, the company will build tall apartments in the new Yongsan Xi and Yeouido Hansung Xi complexes in Seoul and has entered the apartment remodeling business with new contracts for the Apgujeong Misung and New Banpo complexes also in Seoul. Another new area undertaken by the company is constructing light railway lines as part of the government program to help alleviate congestion on the nation's roads.

More and Larger Captive Projects

In 2004, LG-Philips LCD announced plans to invest US$20 billion in new facilities over the next decade, and GS E&C received a ₩1.3 trillion contract to build the first installment of this plan-a 7th-generation TFT-LCD factory. The company also increased the value of orders received from LG and GS affiliated companies, such as LG Electronics, LG Chem and GS Caltex.

Given the nature of the rapidly changing TFT-LCD market, the plant project is being expedited via "fast-track" approach in which design and construction are carried out simultaneously. Thus, project completion is set for 2005. LG Philips also plans to build 8th-, 9th-, and 10th-generation production lines successively. Given the advanced technology and close cooperative relationship being built up in the course of these projects, LCD factory construction looks to be an important growth driver for GS E&C. Captive projects represented 38% of total sales in 2004, up from the 30% figure for the previous year.

Ongoing Pursuit of PFI Projects

Privately-funded infrastructure construction is among the most profitable endeavors for the company. GS E&C sells its operation rights after project completion to free up investment funds for reinvestment in other PFI projects. By 2004, the company has completed and is operating five PFI projects, and two more are currently under construction. At the end of 2004, the company's total investment in PFI stood at ₩252 billion, which is 37% of invested assets and 8% of total assets.

Here are examples of how PFI projects are managed: In 2003, the company sold its equity in the New Airport Highway and Daegu West-North Road to improve its capital liquidity. In 2004, the company negotiated the sale of its ₩113 billion stake in the Cheonan-Nonsan highway to the Korea Road Infrastructure Fund.

Changing Equity in LG Affiliates

At the end of 2004, GS E&C sold part of its shares in LG CNS and LG Energy to comply with laws on affiliate separation and holding company launch. Official separation of the LG and GS Groups begins in 2005.

The LG Card insolvency prompted the company to sell its 4.36% stake in LG Investment Securities in 2004. The equity was transferred to LG Card creditors, who assumed managerial control of LG Card in 2003. GS E&C also purchased ₩50 billion in LG Card CP in 2004 as obligatory support for additional bad debt amassed by the credit card company. Subsequently, ₩12.7 billion of the total was converted into invested capital and the remainder has been retained as CP.

Stronger Knowledge Management

GS E&C has been investing steadily into information technology to respond more effectively to a fast-changing market environment and to raise competitiveness by improving intra-organizational information sharing. In addition, an ongoing effort is underway to acquire intellectual properties such as new technologies, patents, practical new ideas, programs and copyrights.

As a result, the new e-Works program was installed that can links global clients, partners and subcontractors in real time. Meanwhile, the on-site project management system, known as PMS+, continues to be upgraded.

Finally, the new Knowledge Management Team was formed to develop work manuals. Required individual work competencies are also being entered into a database to promote competitiveness over the mid-/long term.

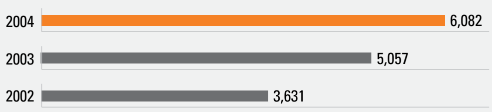
Results of Operations

New Orders

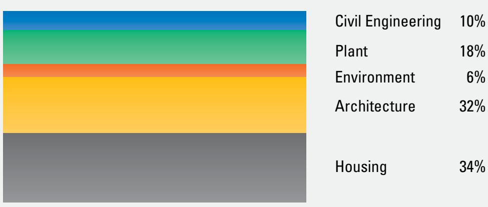
New orders increased 20.3% year on year in 2004 to surpass ₩6.08 trillion, establishing the foundation for steady company growth. Growth in new contracts was particularly strong in the Architecture and Housing Business Divisions, and projects from affiliated companies represented 34% of the total new orders received, boosted by the massive investment program at LG Philips LCD.

NEW ORDERS

(Unit : billions of Won)



NEW ORDERS BY DIVISION



Civil Engineering Business Division

The Civil Engineering Business Division suffered a 10% year-on-year decline in new orders, which totaled ₩613 billion in 2004. The Division represented 10% of the company's total new order business, down 4 percentage points from 2003.

The seven turnkey projects awarded to the Division in 2003 comprised 68% of the total new contracts it received for the year, whereas only 4 turnkey projects, or 44% of the total new business, were obtained in 2004. However, many projects were either postponed or delayed, and the new order volume is expected to pick up in 2005 and beyond.

Importantly, the Division paved the way for market and operational diversification with the award of the turnkey Gulpo River flood control project and participation in the Pyeongtaek Port PFI project. This foundation for business expansion should allow the Division a greater role the company, as civil engineering projects tend to be highly profitable. The Division's involvement in new PFI projects also reached ₩28 billion in 2004, up ₩20 billion from the year before. Despite numerous project postponements, the Division also received ₩317 billion in new general government contracts, an increase of ₩106 billion from 2003. At the end of 2004, the order backlog for the Civil Engineering Division stood at ₩2.45 trillion, up 2% from a year earlier and 25% of the company's total order backlog.

Plant Business Division

The Plant Business Division received just over ₩1 trillion in new contracts in 2004, down 30% from the year before. This figure equals 18% of the total new contracts received for the year.

However, the lower numbers are mainly due to the formation of a separate division for the environment-related projects and the lack of massive new orders such as the ₩670 billion Iranian South Pars Gas Treatment Plant project received in 2003. On a positive note, the Division's order backlog exceeded ₩1.9 trillion at the end of 2004, up 22% year on year and 19% of the company total.

Overall construction demand is forecast grow in 2005, driven up by facilities expansion in oil producing countries in response to recently soaring global oil prices.

Environment Business Division

Public interest in environmental protection is at an all-time high, causing the market to grow rapidly. To meet this surging demand, GS E&C formed a separate Environment Business Division in 2004 and is leveraging its advanced to achieve rapid growth in this segment.

New contracts totaled ₩400 billion, or 6% of the new business for the company, in 2004. In 2003, only one turnkey project in the environmental protection field was secured. A year later, the new Division was awarded four such projects, including sewage conduit repair in Bosung and an advanced sewage treatment plant in Jeonju. Thus, the Division's proven technology and experience have laid the groundwork for future growth.

Architecture Business Division

The Architecture Business Division received ₩1.6 trillion in new contacts from affiliated companies, including the 7th-generation TFT-LCD production facility project for LG Philips LCD. As a result, total new orders were up 70% year on year to just under ₩1.95 trillion in 2004. The Division represented 32% of the new orders for GS E&C in 2004, an increase of 9 percentage points from 2003.

New orders are quickly turned into sales for projects such as LCD factories. Despite this fact, the massive increase in new contracts created a backlog of almost ₩1.17 trillion at the end of 2004, which was 42% higher than the year before. The scope of new work from affiliates coupled with the substantial backlog will provide a solid foundation for future growth.

Of special note, the three turnkey orders received in 2003 totaled only ₩83 billion in value, while the five turnkey orders awarded the following year were worth ₩126 billion, helping to secure the company's leading position in this market segment.

Housing Business Division

The slumping Korean business environment notwithstanding, the Housing Business Division secured more than ₩2.04 trillion in new contracts in 2004, which was 20.9% higher than the ₩1.69 trillion figure for the previous year. As a result, the Division's order backlog increased 31.8%, from over ₩3.05 trillion at the end of 2003 to just under ₩4.03 trillion a year later.

In the housing business, only contracts that have been approved by the government are recognized as "new orders." Substantially more contracts have actually been received and are awaiting government approval. The amount of these provisional order backlog rose 31.3%, from ₩8.67 trillion at the end of 2003 to over ₩11.38 trillion at the end of 2004. Housing Business Division sales increased 2.7%, from more than ₩1.06 trillion in 2003 to over ₩1.09 trillion in 2004. However, the Division's portion of total company sales revenue fell from 34% to 26% during the same period. Despite a 21% rise in new contracts, sales remained about the same because many projects were in their initial stages and their contribution to total sales was small.

Sales Revenue & Profit

In general, construction costs are categorized as materials, labor, outsourcing and other G&A expenses. When apartments are constructed on land owned by the builder, the construction cost will include the land cost. For major construction companies such as GS E&C, outsourcing will comprise 50% of the total cost, and this expense continues to rise in proportion to other costs.

At the end of 2004, outsourcing represented 60% of the cost of sales for GS E&C. This statistic reflects the increasingly important role that project management plays as construction projects become larger and more complex. This also means that material and labor costs increasingly become part of the subcontractors' work scope. The composition of expenses varies according to project type as well. Outsourcing expenses are relatively high for civil engineering and architecture projects, while the material cost portion is lower. On the other hand, plant and apartment projects will incur higher costs for materials while outsourcing is less prominent as an expense.

Here is a look at changing costs for construction materials (based on Producer Price Index, or PPI, data from the Bank of Korea covering unprocessed and processed industrial materials; 100 represents the year 2000): Raw materials used in construction rose 24.7% on the PPI, from 118.0 at the end of December 2003 to 147.2 a year later. During the same period, the index for intermediate construction materials moved from 112.5 to 129.4, a 15% increase. Thus, the cost of raw materials rose faster than that for intermediate (or processed) materials. The BOK data show, for example, that the price for regular reinforcement bar surged 33.2% during the one-year period, from 134.4 on the index to 179.0. The rising costs naturally exert downward pressure on the company's gross margin.

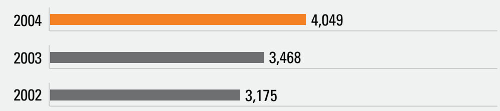
Sales Revenue

GS E&C's operations are currently divided into the civil engineering, plant, environment, architecture and housing sectors. The rapid growth in demand for environment protection facilities prompted the company to form a separate unit, independent of the Plant Business Division, for this business segment.

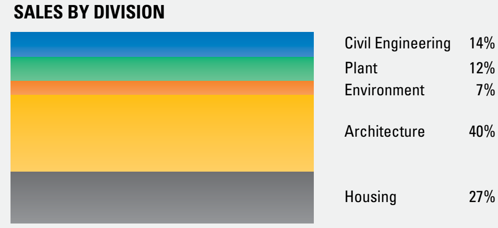
Sales rose 16.8%, from nearly ₩3.47 trillion in 2003 to just under ₩4.05 trillion in 2004, boosted by the Architecture Business Division's rapid progress on TFT-LCD factory projects. This also increased the sales portion of captive projects from 30% in 2003 to 38% of total sales in 2004. The recent rise in oil prices has also led to increased orders from oil producing countries, driving up overseas sales revenue from 8% to 10% of total sales.

SALES REVENUE

(Unit : billions of Won)



SALES BY DIVISION



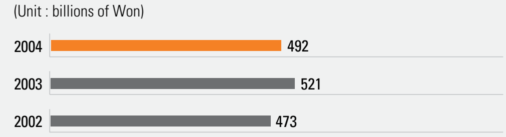
Gross Profit

Construction work costs in 2004 break down as 59% for outsourcing, 24% for materials and 17% for other G&A expenses. This was similar to the 60%/23%/17% cost configuration for 2003. The increase in the material cost portion was mainly due to higher raw material prices and to the increase in architecture projects, which incur relatively high material costs, while the amount of civil engineering projects, which require fewer materials, fell.

Rising raw material prices and worsening market conditions brought on by intensified competition caused gross profit to fall 5.6% year on year to ₩492 billion in 2004. Gross margin was also slid to 12.2%, from 15.0% in 2003.

GROSS PROFIT

(Unit : billions of Won)



Operating Profit

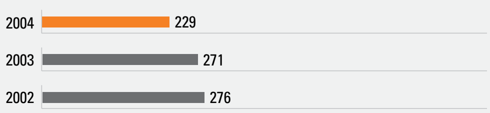
The company earned ₩229 billion in operating profit in 2004, a 15.5% decline year on year. Likewise, the operating profit margin dropped from 7.8% to 5.7% because gross profit was ₩29 billion lower than the 2003 figure. At the same time, sales and administrative expenses rose 5.4% to ₩263 billion, causing the ratio of S&A expenses to sales to drop from 7.2% in 2003 to 6.5% in 2004.

This increase in S&A expenses reflects efforts to break into new fields and to lay the groundwork for long-term growth, with the ultimate goal of leading Korea's construction market. Part of the rising cost is attributed to pay hikes for employees and the establishment of a new Customer Service Center by the Housing Business Division to maximize customer satisfaction.

Meanwhile, the company is aggressively pursuing turnkey projects in order to build the foundation for steady growth. As part of this effort, more is being invested in technology development, including money paid to outside design specialists, driving the associated expenses up from ₩74 billion in 2003 to ₩76 billion in 2004. The Housing Business Division must also continue to make outlays in order to secure new contracts for residential redevelopment and apartment reconstruction.

OPERATING PROFIT

(Unit : billions of Won)



Ordinary Profit

Ordinary profit for 2004 totaled ₩242 billion, down 7.6% from the ₩262 billion recorded the year before. However, the balance between non-operating income and non-operating expenses improved by ₩23 billion during 2004.

One-time expenses surged as a result of ₩14 billion in LG Card CP impairment losses, a ₩23 billion loss from the disposal of LG Investment Securities shares, and the payment of an additional ₩12 billion in income taxes for prior years. As a result, non-operating expenses increased ₩40 billion, from ₩47 billion in 2003 to ₩87 billion in 2004.

On the other hand, non-operating income rose ₩62 billion, from ₩38 billion to ₩100 billion over the same period. This figure includes a ₩29 billion increase in foreign exchange gains (gains losses on foreign currency transactions/losses on foreign currency translation and derivatives transactions/valuation losses) resulting from an effective currency exchange risk management effort.

Second, the equity method applied to invested corporations in which the company has a stake of 20% or more resulted in the conversion of a ₩16 billion loss in 2003 into a ₩2 billion gain in 2004. (GS E&C has excluded PFI Companies such as Seoul Beltway Co. from this equity valuation method since 2002 based on the opinion of the financial supervisory service)

Thus, Hanmoo Development, which comprises the largest portion of GS E&C's invested stocks, has been converted into a gain. Meanwhile, the decreased value of fixed assets belonging to Ladera, a local subsidiary on Guam, was shown as an ₩11 billion loss on evaluation of equity method in 2003, but that figure does not appear on the books in 2004.

Third, interest rates for financing have fallen and borrowings have been converted into net cash flow, improving interest income by ₩12 billion.

ORDINARY PROFIT

(Unit : billions of Won)

Extraordinary Income & Loss

When the foreign currency figures in the financial statements for overseas invested companies are converted into Won, the balance sheet entries are based on the exchange rate prevailing for the Balance Sheet date (but capital account conversions are calculated according to date of acquisition). On the other hand, the average exchange rate for the fiscal period is applied for Income Statement entries, resulting in gains or losses on foreign currency translation. These figures are entered in the Overseas Business Translation Credit/Debit accounts, which either add to or deduct from shareholders' equity. Should overseas branches or other operations be closed, the gains or losses are applied in that same fiscal year.

Therefore, the overseas business translation debit of ₩12 billion is amortized in 2003 as an extraordinary loss, and ₩5 billion is also amortized as an extraordinary loss in 2004. As a result, an business operation translation credit of ₩1.6 billion remained as a capital adjustment within the Shareholders' Equity account at the end of 2004.

Financial Position

Cash Flow

Cash and cash equivalents, which stood at ₩99 billion at the end of 2003, rose to ₩262 billion during the following year. Following is a description of changes in cash flow for each activity type:

First, operating cash flow increased to ₩230 billion in 2004 as a result of ₩156 billion in net income, ₩78 billion in non-cash income and expenses as well as a ₩4 billion cash outflow from changes in operating assets and liabilities.

Trade accounts and notes receivables were ₩238 billion higher at the end of 2004 than they were a year earlier, rising faster than the sales revenue growth rate. This was mainly due to increased sales from affiliated companies. On the other hand, trade accounts and notes payable also increased ₩175 billion.

Second, investment activities generated a cash inflow of ₩7 billion after the sale of LG Investment Securities shares and the partial sale of equity in LG CNS and LG Energy to satisfy the legal requirements for separating from the LG Group. At the same time, a cash outflow of ₩179 billion resulted from payments for long-term investment securities and assets for construction projects now in progress.

Third, cash flow from financing activities rose ₩112 billion during 2004. An increase in borrowings coupled with a reduction in corporate bonds increased cash flow by ₩81 billion and strong sales of memberships to a golf course on Jeju Island also raised ₩91 billion. Meanwhile, a total of ₩62 billion was paid out in dividends.

Capital Expenditures

Much of the company's capital expenditure in both 2003 and 2004 was directed at the construction of the Elysian Country Club on Jeju Island, and the project was completed in 2004. GS E&C capital expenditure came to ₩134 billion in 2004, a 60% increase over the ₩5 billion figure for the previous year.

Large construction companies such as GS E&C invest in project companies in the process of performing PFI projects. Technically, this is not classified as CAPEX, but it is similar because it is directly linked to generating income and new orders.

A PFI project involves both construction companies and financial institutions, who jointly establish the project company. Participants' invested capital, borrowings and national treasury funds are used to finance the construction of roads, railways, ports, sewage treatment plants and other infrastructure. Once built, the project company operates the infrastructure for a fixed period to generate revenue. Construction companies that take part in PFI projects invest in the project company, providing them with the opportunity to earn revenue by carrying out various construction orders for the project company. Once the construction work is completed, the construction company can either collect a share of the income generated, proportionate to equity owned, or it can withdraw cash by selling its stake.

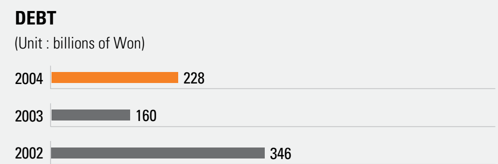
GS E&C's first PFI project was the New Airport Highway construction. The company initially invested ₩2 billion in 1995, followed by additional investments of ₩48 billion in 2002, ₩36 billion in 2003 and ₩36 billion in 2004.

The company may try to liquidate its investment while the construction work is still underway or after it is complete. For example, GS E&C sold ₩22 billion worth of its equity in the New Airport Highway to the project company in 2003 and was repaid ₩3 billion from the Daegu West-North Road project in 2004. An agreement was reached in 2004 to repatriate ₩113 billion of the GS E&C equity investment in the Cheonan-Nonsan Highway project. Of this total, ₩56 billion was returned in February 2005 and the rest is to be paid back before the end of the year. In this way, the company keeps circulating its capital for reinvestment in other projects to maximize return.

GS E&C is currently involved in a number of PFI projects and will continue to invest in new ones in the future.

Borrowings

Total borrowings increased by 68 billion in 2004, from ₩160 billion at the end of 2003 to ₩228 billion a year later. Of the total, 72% (₩164 billion) is in short-term loans, including ₩151 billion in low-interest, trade-related loans such as the manufacturing financing provided by Korea Exim Bank and usance LCs. Long-term loans include ₩15 billion in borrowings from Korea Housing Guarantee Co. and ₩50 billion in corporate bonds; the latter will mature in 2007.



Equity

The number of shares issued by the company stood at 51 million on December 31, 2004. All shares are common stock; there are no preferred shares, convertible bonds or bonds with warrant. Chairman Chang-Soo Huh and other members of the Huh family hold 30.4% of the total shares issued. Treasury stocks and employee-held stocks amount to 1,271,040 shares, or 2.5% of the total. In 2004, the company purchased 85,806 shares of treasury stock and provided them to employees, and additional purchases and provisions to employees will be made in the future.