

# Management's Discussion and Analysis

## Construction Market

### Construction Market in 2005

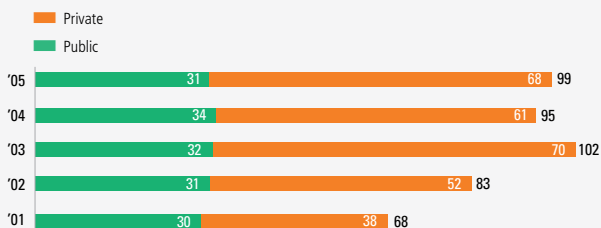
Construction market conditions in Korea were adversely affected by delayed economic recovery and a government crackdown on real estate speculation. The government's Building Construction Permit and the number of new construction orders issued are primary indicators of market activity. BCP in 2005 totaled 112 Mil. m<sup>2</sup>, down 5.1% from the 117 Mil. m<sup>2</sup> registered for the year before. Within this figure, delayed economic recovery drove commercial-use BCP down 24.5% year on year to 23 Mil. m<sup>2</sup>.

New orders were valued at over ₩99.38 trillion, up 5.1% from 2004. The proportion of public sector orders to private sector orders was 33:67.

Despite the small increase in new order value, the total figure includes many reconstruction and redevelopment projects. The amount of newly broken ground did not increase, and the construction industry as a whole contracted.

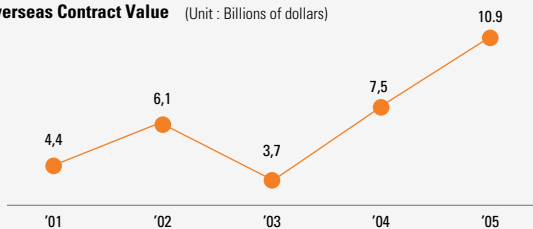
On the other hand, skyrocketing oil prices brought a surge in new construction orders outside Korea, particularly from Middle Eastern countries. Overseas orders rose 45%, from US\$750 billion in 2004 to over US\$1.08 trillion a year later.

**Domestic Contract Value** (Unit : Trillions of Won)



(Source: Ministry of Construction & Transportation)

**Overseas Contract Value** (Unit : Billions of dollars)



(Source: Ministry of Construction & Transportation)

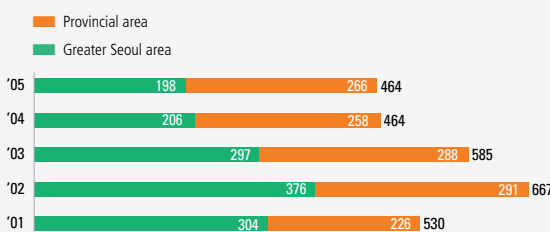
### Housing Market in 2005

Housing prices had remained relatively stable since the end of 2003, but sharp rises occurred in 2005, led by apartment prices in southern Seoul, Bundang, and Yongin. In response, the Korean government announced a series of measures on August 31 to stable the housing prices through speculative demand suppression and restitution

of development gain. The announcement of the measures disrupted certain parts of the market and helped to stabilize prices somewhat. However, passage of the measures into law has been delayed and the market reaction was that such actions did not constitute fundamental reform. Subsequently, prices have begun to go back up, particularly for apartment reconstruction in Gangnam (southern Seoul).

During 2005, a total of 463,641 new residences (73% private sector and 27% public sector) were supplied, which did not meet the government target of 520,000 units. The rate of new residents supplied fell year on year in the Greater Seoul area but was up in the rest of the country. Noteworthy is the steady rise in portion of new units supplied by the nation's top construction companies from the increasing importance of apartment brand names.

**Housing Supply** (Unit : Thousand Houses)



### Construction Market in 2006

No major changes are expected in the overall market in the coming year, and conflicting signals abound. The government budget for new infrastructure projects will be lower than it was in 2005, while tighter real estate regulations and higher taxes will also dampen market sentiment. On the other hand, the local government elections and increased public development projects should help to stimulate the market.

The proposed government budget will be 4% higher than in 2005 to surpass ₩27.46 trillion. Of this total, ₩8.3 trillion is earmarked for BTL and related projects.

The total construction orders issued in 2006 will reach ₩97 trillion, a 1.6% drop year on year reflecting curtailed activity in the housing sector.

In its 2006 forecast the Construction & Economy Research Institute of Korea says Building Construction Permit and new orders will rise only 0.9% from 2005. Such lackluster growth suggests that Korea's overall economic recovery will be delayed further, considering the linkage effects that the construction industry has on other sectors. However, the overseas construction market will continue to show robust growth and new orders received by Korean construction companies are forecast to be 20% higher than they were in 2005 to reach US\$13 billion.

## Housing Market in 2006

Apartment prices are likely to fall somewhat as the government continues its market stabilization policy and adverse market sentiment. However, the range in which prices drop will be limited. Sales of new apartments are expected to be slow in the first half but then rebound in the second half.

Demand perpetually exceeds supply, and measures are now most urgently needed to address this imbalance over the mid-/long term. A look at housing related indicators starkly reveals the need for greater supply. The domestic housing availability rate still lags behind that in advanced countries: 249 units per 1,000 people in Korea (CERIK, 2005) as opposed to 399 in Japan, 417 in the UK, and 419 in the US.

The Korean government has announced a housing supply target of about 520,000 units in 2006, most of which are to come in redevelopment projects. Projects that have been delayed in Pangyo, Paju and other areas near the capital are forecasted to go forward in the coming year.

## Summary of Operations

### Highest New Orders and Sales in Korean Construction Industry

Economic growth was slow in Korea in 2005 and construction activities fell across the board. In the face of such adversity, GS E&C maintained a balanced portfolio (civil engineering, plants, environmental facilities, office buildings and housing) to surpass ₩8.2 trillion in new orders and exceed ₩5.6 trillion in sales. There were the highest figures for any Korean construction company during the year. Such performance was made possible by steady investment in and attention on developing new technology and improving order taking capabilities. The quantitative growth has put GS E&C on the top of the domestic construction industry.

### Stable and Steady Growth in New Orders

New orders exceeded ₩8.2 trillion in 2005, which was more than ₩2 trillion higher than the ₩6.1 trillion total achieved in the previous year. This was accomplished while the volume of Korean government contracts dropped in 2005 and new apartment demand fell after a government crackdown on real estate speculation. Indeed, GS E&C won orders for noteworthy projects in many fields, demonstrating once again its potential for steady future growth.

Moreover, the company has focused on winning the more-lucrative turnkey projects rather than participating in projects that are awarded to the lowest bidder. As a result, nine turnkey projects were received in the civil engineering sector in 2005 as opposed to only four the year before. The company also garnered seven environment-related

turnkey projects in 2005, establishing a competitive edge in the field.

The target for new orders in 2006 has been set at ₩8.8 trillion. To achieve this goal, GS E&C aims to supply more apartments built on company-owned land as well as to secure more orders for plants and environmental facilities, orders from non group clients, turnkey projects and PFI projects.

### An Abundance of Group Projects

GS E&C has maintained excellent relations with all the current and former LG companies since the split-up of the group. The company received ₩2 trillion in new group contracts in 2004 and ₩2.1 trillion more from the affiliates in the current GS, LG and LS Groups in 2005. The portion of the group sales in the overall portfolio has remained steady: 38% in 2004 and 39% in 2005.

One of the most important group projects is the massive investment being made by LG Philips LCD in Paju, Korea. The 7th-generation LCD production line has been almost completed and now an 8th-generation facility is under construction. Meanwhile, GS Caltex is planning a major investment and LG Electronics, LG Chemical and other group companies are expected to invest steadily in new facilities. Thus, GS E&C is confident of having a stable platform for growth from this group segment.

### Growth from Overseas

The high oil prices in 2005 prompted oil producing nations to increase their investments in new facilities, and orders were up sharply worldwide. GS E&C benefited from the growing demand, winning ₩1.09 trillion worth of new projects outside Korea in 2005, which was 27% higher than the ₩860 billion figure posted in 2004. Importantly, GS E&C has extensive experience in building oil refineries, gas processing plants and petrochemical plants, which lowers the risk in new projects undertaken. The company has managed to secure some highly profitable contracts thanks to its improved design and estimation capabilities as well as to the improved business conditions in the Middle East. Plans call for increasing the company's share of the overseas gas plant projects.

### PFI Project Competitiveness

Prospects for public contracts have not been bright of late. Order volume has decreased and competition over the remaining orders has intensified, prompting the government to reduce its project budget. To break away from this vicious cycle, GS E&C has been going after Privately-Funded Infrastructure projects. In-house funding of PFI projects is being stepped up to boost profitability and stimulate growth in the civil engineering sector.

Among the noteworthy accomplishments in 2005, GS E&C was selected to be the prime contractor for the Uijeongbu PFI light railway

# Management's Discussion and Analysis (Continued)

and Pyeongtaek Port projects. The company is waiting for government approval on 8 PFI projects as of the end of 2005. The direction in which the company is going should pave the way for more light rail, port and subway projects. As the company leverages its technology to enter new business areas, the position and profitability of the Civil Engineering Business Division will be raised. The equity invested in previous PFI projects has been sold off, but the company will retain equity in projects with sufficient profitability and will generate additional revenue for operating PFI facilities.

## Sales Revenues & Profits

### Sales Revenues

The five main business divisions of GS E&C are Civil Engineering, Plant, Environment, Architecture and Housing, and their growth has been even across the board. Sales were robust in all five sectors, boosting total sales 39.1% from just under ₩4.05 trillion in 2004 to more than ₩5.63 trillion in 2005, the highest figure for the entire domestic construction industry.

Rapid progress on the TFT-LCD plant project in Paju, Korea helped to bring the group portion of total sales back to 39%, the same as in 2004. Overseas plant projects contributed the most to overall sales growth. The recent spike in oil prices has driven up new facility demand in oil producing countries, increasing the weight of overseas projects in the GS E&C sales portfolio from 10% in 2004 to 16% in 2005. Despite a difficult domestic market, meanwhile, sales growth was sustained in the housing sector, led by projects for developers. The company's industry-high sales demonstrate that the diversified portfolio provides stability.

### Gross Profit

Gross profit for 2005 reached ₩680 billion, which was 38% higher than the ₩492 billion for 2004, despite increased competition and worsening business conditions. Gross margin was 12.1%, about the same as the 12.2% figure for the previous year. The gross margin for the Civil Engineering, Plant and Environment Business Divisions was higher year on year, while the profit margin was down slightly for the Architecture and Housing Business Divisions. The total construction cost breaks down as 59% for subcontractors, 27% for materials and 14% for land and other expenses. The proportions for 2005 do not differ greatly from the 59:24:17 cost configuration in 2004. This is due to the expansion of plant projects, which require a high percentage of materials.

### Gross Profit (Unit : Billions of Won)



### Operating Profit

Operating profit was ₩336 billion in 2005, a 46% increase over the year before. The operating profit margin improved from 5.7% to 6.0% during the period. This rise stemmed from a lower ratio of SG&A expenses to sales, even through the SG&A expenses were higher year on year. The portion of SG&A expenses in total costs fell from 6.5% in 2004 to 6.1% in 2005, part of a continuing downward trend since 2003, when SG&A expenses were 7.2%.

Important factors driving SG&A expenses are steady operational growth and greater payouts to advance the more lucrative business activities. Growth is accompanied by a larger workforce and higher wage expenses, while more must be spent on R&D and advertising as well. Technology development costs such as outsourced design services continue to escalate as part of activities to win the turnkey projects that elevate overall profitability. The company spent ₩91 billion on project development related expenses in 2005, which was 20% more than the ₩76 billion spent during 2004. A greater effort was made to raise competitiveness in turnkey projects. The new company name and aggressive "Xi" apartment brand promotion also boosted advertising by ₩18 billion from the previous year.

### Operating Profit (Unit : Billions of Won)



### Ordinary Profit

Ordinary profit rose 52%, from ₩242 billion in 2004 to ₩367 billion in 2005. The non-operating gain increased by ₩18 billion, from ₩13 billion to ₩31 billion. The 2005 non-operating income of ₩108 billion was ₩8 billion higher than in 2004, while the company posted non-operating losses of ₩77 billion in 2005, which was ₩10 billion lower than the year before.

A closer look will show several factors that have contributed to these changes. To begin with, ₩7 billion was recovered from the 2004 impairment loss from LG Card commercial paper and stocks upon their maturity (a partial debt-equity swap was conducted in 2005). Sale of the stocks brought an additional ₩15 billion, and another ₩12 billion was generated from the sale of tangible assets.

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 loss into a gain in 2004. An additional gain of ₩3 billion was realized in 2005 as the profitability of invested equity assets continued to rise.

Third, ongoing efforts to hedge against foreign exchange risk have included the use of foreign exchange rate risk insurance and forward transactions. The Exchange Rate Risk Management Committee, which was formed in 2004, has managed to minimize risk from exchange rate fluctuation, with an eventual goal of 100% hedge against exchange rate risk.

#### Ordinary Profit (Unit : Billions of Won)



## Financial Position

### Cash Flow

Cash and cash equivalents, which stood at ₩262 billion at the end of 2004, rose to ₩358 billion during the following year. Following is a description of changes in cash flow for each activity type:

First, operating cash flow increased by ₩73 billion in 2005 as a result of ₩265 billion in net income, an ₩80 billion increase in non-cash income and expenses, and a ₩272 billion cash outflow from changes in operating assets and liabilities.

Trade accounts and notes receivables were ₩359 billion higher at the end of 2005 than they were a year earlier, rising faster than the sales revenue growth rate. This was mainly due to increased sales from plant and housing projects. On the other hand, trade accounts and notes payable also increased by ₩96 billion.

Second, investment activities generated a cash inflow of ₩226 billion after the sale or maturity of LG Card shares and CPs, and the sale of LG EPS (formerly LG Energy) shares.

Third, cash flow from financing activities fell by ₩50 billion. The disposal of treasury stocks to pay bonuses resulted in a ₩2 billion cash inflow and sale of memberships to a Jeju Island resort resulted in a ₩26 billion increase in cash flow. Conversely, repayment of short-term borrowings generated a ₩15 billion cash outflow, and ₩62 billion was paid out in dividends.

### Dividends and Investments

GS E&C paid ₩1,250 per share in dividends in 2004 and decided to pay ₩1,400 per share for 2005. Consequently, the total dividend payout increased from ₩62 billion to ₩70 billion.

After some profits were distributed in the form of dividends, the

company invests mainly in the promotion of the most lucrative business activities such as apartment complexes on company-owned land, PFI projects and development projects. This investment is aimed at further boosting corporate value in the future. The company invested ₩134 billion in such activities in 2005, which was 57% lower than the previous year's figure, but greater investment is planned for company-owned apartment construction and PFI projects in the future, including ₩255 billion for 2006.

### Borrowings

Total borrowings were ₩208 billion at the end of 2005, a ₩20 billion drop from a year earlier. Of this total, 70% (₩146 billion) is in short-term loans, including ₩144 billion in low-interest, trade-related loans such as the export financing provided by Korea Exim Bank and usance LCs. Long-term loans include ₩13 billion in borrowings from Korea Housing Guarantee Co. and ₩50 billion in corporate bonds that will mature in 2007.

### Equity

The number of authorized stocks by the company stood at 200 million on December 31, 2005. All the issued shares, which number 51 million, are common stock; there are no preferred stocks, convertible bonds, or bonds with warrant. Chairman Chang-Soo Huh and other members of the Huh family hold 30.4% (15,496,248 shares) of the total shares issued. Another 2.2% (1,109,831 shares) of total shares are in the form of treasury stock or part of the employee stock sharing program. Foreign investors own 44.4% of the total shares.