

# Management's Discussion and Analysis

## Construction Market

### News Highlights for 2006

#### 1. Government Real Estate Policy

The purchase price of apartments continued to climb in Korea during 2006, prompting the government to announce a series of measures aimed at curbing price speculation. However, the market remained volatile despite government moves to increase the housing supply and to lower the prices of apartments sold in advance of construction. Some analysts even suggested that the government intervention had exacerbated market volatility.

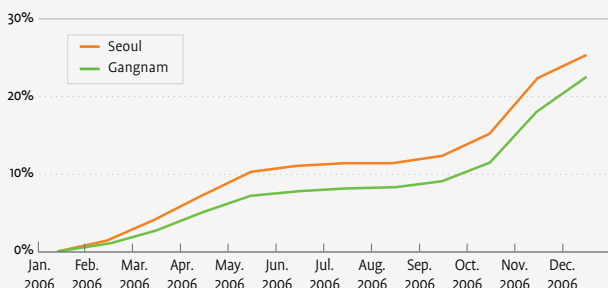
The government insisted that housing prices had stabilized in the wake of measures announced in August 2005 and March 2006. However, the actual apartment prices merely dipped and then began rising again. Finally, the government initiated a market-friendly policy in November 2006 aimed at boosting housing supply. However, the effects of the policy did not meet expectations, and apartment prices remained unstable.

The government then, as a last resort, announced in 2007 that construction companies would have to disclose construction costs publicly and that a price cap would be set on new apartments. Once the legal details have been settled, these new measures are expected to have an effect on the market. However, market watchers say that this will now be a fundamental cure the problem so long as supply does not meet demand.

#### Major Real Estate Policies Announced by the Korean Government in 2006

Promulgation Date	Gist of the Policy
March 30	Pay back excess profit from redevelopment projects, further restrict the debt-to-income ratio on mortgage loans for home in districts designated "speculation zones"
October 27	Establish two more localities for focused development (Geomdan in Incheon and Wooncheong in Paju)
November 15	Expand housing supply, control demand by lowering the loan-to-value ratio and further tightening the debt-to-income ratio restrictions, cut new apartment prices by 25%

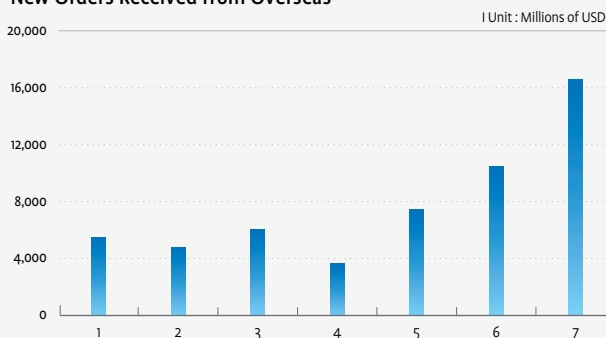
#### 2006 Apartment Sales Prices



#### 2. Overseas Orders Reach a Record US\$16.5B

The Korean construction market, like the overall economy, slowed down in 2006, but Korean construction companies secured a record of US\$16.5 billion in new orders from outside the country. This is the highest total since 1965, when the first Korean construction projects were begun overseas, and significantly exceeds the previous record of US\$14 billion, set in 1997. The strong performance can be attributed to a spurt of new facilities construction in the Middle East, fueled by high oil prices, as well as the improved competitiveness of Korean builders. Thus, a continued growth in overseas orders is likely.

#### New Orders Received from Overseas



By region, the figure breaks down into US\$9.5 billion (58% of the total) for the Middle East and US\$4 billion for Asia (up 55% year on year), with strong growth in new orders from customers in Vietnam, the Philippines, and China. Korean construction firms also diversified their overseas markets by winning orders in Africa and Central Asia.

A noteworthy development in 2006 was the new growth momentum generated by the US\$1.6 billion (some 10% of the total) in orders for invested development projects overseas. Continued growth is expected in urban development projects that include housing complexes. Finally, the number of large-scale projects (at least US\$100 million) rose to twenty-seven, valued at US\$12.4 billion.

#### 3. Contraction in the Korean Public Construction Market

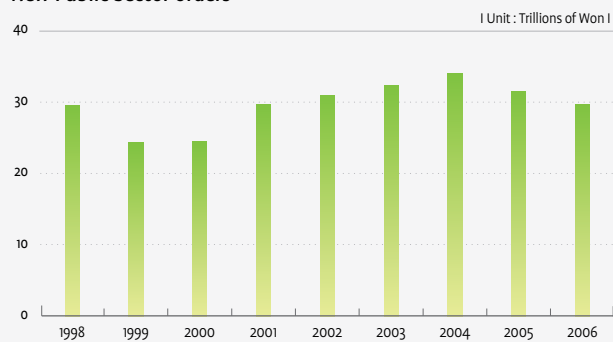
Statistics from the Korean National Statistical Office show that the government issued five percent fewer orders in terms of monetary value in 2006 than in the previous year. The amount of decline was small. However, this was the lowest total in the past three years, as many project tenders were delayed and the government adopted a new policy for awarding projects to the lowest bidder instead of to the most qualified bidder.

A revision to the enforcement ordinance for the National Contract Law in May 2006 expanded the range of the lowest bidder

requirement for pre-qualifiers from projects of ₩50 billion or more to all projects that are worth at least ₩30 billion. The revised enforcement ordinance covers forty percent of all government contracts, as opposed to the previous twenty-five percent. The average asking price of the successful bidders for government lowest bidding projects was only sixty-eight percent of the government's original budget in 2006, which was thirteen percentage points lower than in 2005.

The change in the bidding award system has resulted in a drop in the volume of new projects issued by the government. In addition, the government's budget enforcement was postponed, greatly reducing the orders received for government projects and the value of construction completed. As a result, the overall market for Korean government contracts shrank during 2006.

#### New Public Sector orders

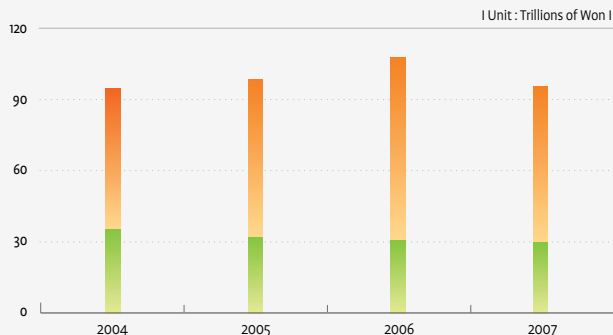


### 2007 Construction Market Outlook

#### 1. New Orders Expected to Fall Below ₩96T

A rush in redevelopment projects during 2006 will naturally mean a slowdown in this segment during 2007. This is expected to lower the total new contracts in the Korean construction market to ₩95.7 billion in 2007, from the ₩107.3 figure posted during the

#### Total New Orders



previous year. The government budget for infrastructure projects is expected to be somewhat higher in the coming year, but railway projects are increasingly being turned over to PFI consortia. As a result, the total volume of new government contracts should be around 1.6% lower than the 2006 figure.

Office building construction in the private sector is forecasted to fall 5.2% year on year. The government's new policies regarding real estate have caused the volume of real estate transactions to fall overall, and advance sales of office space in provincial areas remain sluggish.

Turning to the housing sector, the construction company now must be selected for redevelopment projects (apartment complexes built on old private home sites) after the project is approved by the government. On the other hand, a housing cooperative has to be established before the builder can be selected for apartment complex reconstruction. These new requirements are expected to cause a sharp decline in new orders in these two sectors. On the other hand, large-scale complexes of pre-sold apartments are planned for in Paju (Wooncheong area), Suwon (Gwanggyo area) and Seoul (Ddukseom area).

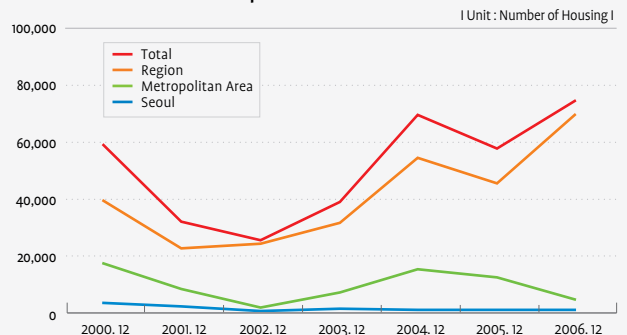
The slowdown in construction activity greatly affects the domestic economy and the job market. Thus the government is likely to adjust its efforts to curb real estate speculation.

#### 2. Housing Market to Stabilize

Housing prices in the Greater Seoul Area now seem to be stable and only rising as fast as goods and services in general. The pre-sold apartment market (where buyers pay the builder before construction begins) is expected to shrink, especially in Korea's provincial regions. Suppression of rising apartment prices will be difficult given the inadequate supply overall, but the rate of increase is expected to be limited.

The government is forecasted to maintain its anti-speculation stance. However, the National Assembly has delayed its ratification of the latest real estate policy announced on January 11 and the

#### Trends for unsold unit in Apartments



# Management's Discussion and Analysis (Continued)

rapid contraction of the housing market outside Greater Seoul has curtailed construction activity. In addition, a Presidential election is coming up. All these factors are increasing the likelihood of a policy change by the central government.

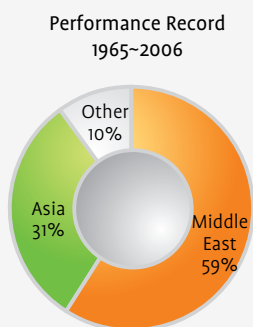
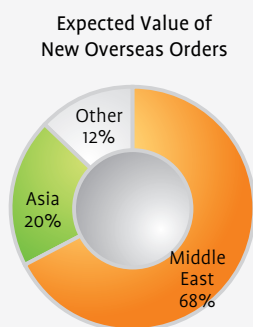
Thus, polarization in the construction market is predicted to continue between the Greater Seoul Area and the rest of the country. At the same time, differences in brand recognition and location will continue to widen the gap between the large construction companies and their smaller counterparts in 2007.

### 3. Overseas Boom to Boost New Orders to US\$18T

Korean construction companies are anticipated to receive US\$18 billion in new orders outside the country in 2007. Continued high oil prices should drive steady demand for new plant construction in the Middle East, although the portion of business in Asia and Africa is expected to drop somewhat from the 2006 level.

Plants will remain the largest portion of the overseas construction portfolio, as oil and gas development increased in the Middle East and North Africa, and petrochemical plant orders continue to rise. The global construction market will increase overall. Market opening pressures such as WTO entry will also mean that Korean construction companies will continue to find more of their business overseas.

#### Expected Value of New Orders in 2007



## Summary of Operations

### Steady Quantitative Growth

Korean construction activity contracted during 2006 as the result of a lackluster domestic economy and the government's corresponding real estate policy. However, GS Engineering & Construction leveraged a well-balanced portfolio and strong competitiveness to achieve the industry's highest totals for new orders (₩9.13 trillion) and sales (over ₩5.74 trillion) for the second

straight year. Moreover, the prestigious US journal Engineering News-Record placed GS E&C thirty-first among the top 255 global contractors, the highest ranking for a Korean builder.

Despite the adverse market conditions, GS Engineering & Construction managed to achieve sufficient quantitative growth to satisfy investors in 2006. The company also demonstrated again that it can continue to grow in the future. Management aims to increase new orders to ₩10.4 trillion (up fourteen percent year on year) and sales to ₩6.5 trillion (a thirteen percent gain) during 2007.

### Surging Overseas Orders

The volume of new overseas contracts mainly for plants in the Middle East rose sixty-four percent, from ₩1.09 trillion in 2005 to just under ₩1.79 trillion in 2006. Of this total, a single aromatics plant project in Oman is valued at ₩1.1 trillion, a new company record. Moreover, the effort to diversify overseas markets yielded a linear alkyl benzene plant project in Egypt, paving the way for additional orders from African clients in the future.

Overseas, GS E&C has hedged against risk by remaining focused on oil refineries, gas production facilities and petrochemical plants. In the future, the company will selectively bid on projects with high margins.

### Improved Profitability

In the past, GS E&C stressed business volume over profit margins, but the priority was redirected toward value growth through cost innovation in 2006. To this end, the company adopted the Total Project Management System and formed a working-level deliberation committee to assist in the selection of the most profitable projects. A company-wide cost-cutting campaign was also implemented. These collective efforts brought tangible results, as the gross profit margin rose 1.2 percentage points year on year to 13.3%; operating profit was up 1.0 percentage points to 7.02% and ordinary income was 2.9 percentage points higher to 9.47%. The new TPMS is expected to play a pivotal role in shortening processes and project times as well as cutting costs by eliminating unnecessary delays.

## Results of Operations

### Orders Received

New orders totaled ₩9.13 billion in 2006, a 10.8% increase over the previous year and the highest growth rate in the domestic construction industry. Importantly, this growth was achieved during a year when Korean construction activity contracted. The

strongest gains were recorded by the Plant and Housing Business Divisions. The slowdown in Korean government contracts was offset by a surge in overseas plant orders, particularly in the Middle East. Moreover, the company saw a steady increase in apartment construction despite a sluggish domestic real estate market.

In accounting, GS E&C classifies newly received housing projects as either “new orders” or “provisional order backlogs” In the latter case, the outside developer or housing association has selected GS E&C as the contractor, but the project is still awaiting government approval. Once approval is granted, the accounting status will be changed to “new order.”

The new order backlog stood at ₩15.1 trillion, while pending contracts totaled ₩18.5 trillion, for a grand total of ₩33.6 trillion at the end of 2006. Based on 2006 sales, this is enough work to keep the company operating at full capacity for 5.9 years.

#### **Civil Engineering Business Division**

The Korean government postponed bids on many projects and adopted a new system that awards contracts to the lowest bidder. For these reasons, new orders for the Civil Engineering Business Division fell twenty-three percent from the 2005 figure to ₩609 billion. The Division, however, enhanced its capabilities to win new government contracts by upgrading technology as well as the sales organization.

The focus was put on privately-funded infrastructure projects (₩177 billion in new orders received) and turnkey projects (seven contracts were signed, totaling ₩329 billion). Importantly, the Division continued to strengthen its position in the turnkey segment, achieving a bid success rate of seventy percent. The order backlog for the Division at year’s end exceeded ₩2.4 trillion, or sixteen percent of the company total.

#### **Plant Business Division**

The Plant Business Division originally expected to receive ₩1.5 trillion in new orders but exceeded that target by one hundred fifty-two percent to reach ₩2.28 trillion. The 2006 total was also fifty-four percent higher year on year. The Division demonstrated its superior technology and competitiveness by negotiating a massive aromatics plant project in Oman rather than by competing for the contract in a tender. Meanwhile, efforts to diversify outside the Middle East resulted in a linear alkyl benzene plant project in Egypt.

The increase on overseas orders is attributable to high oil prices, which have boosted demand for new petroleum and gas production facilities, as well as to the Division’s stronger competitiveness. Therefore, further growth in the overseas business can be expected. In addition, governments, especially in

the advanced countries, are steadily tightening environmental regulations, driving demand for clean-burning LNG and other environment-friendly fuels. The environmental segment will make up an increasing portion of the Division’s portfolio in the future.

#### **Environment Business Division**

The Environment Business Division received a total of ₩300 billion in new orders in 2006, a year-on-year drop due to numerous delayed government tenders. However, the Division still retained a leading position in the Korean environmental facilities by winning eight turnkey projects representing diverse areas--waste processing, incineration, advanced water treatment and sewage treatment. Moreover, the order backlog at year’s end totaled ₩480 billion, which was higher than the figure posted a year earlier.

Environment Business Division still contributes the smallest amount to the company’s business portfolio, but it has acquired extensive experience and technology in the performance of projects for GS, LG and LS affiliates. The fundamentals are now in place for rapid growth in the public sector. Meanwhile, the Division continues to strengthen competitiveness through new technology development and acquisition, laying the groundwork for expansion into new business areas and overseas markets.

#### **Architecture Business Division**

The Korean market saw a slowdown in government contracts, but the Architecture Business Division managed to garner more than ₩2.43 trillion in new orders, thanks to a steady stream of work from the “group” clients. Namely, projects for LG Philips LCD, LG Electronics and LG Telecom amounted to ₩1.7 trillion, about the same volume of internally generated business as in 2005.

Meanwhile, the Division saw an increase in business from outside the “group.” New public orders amounted to ₩284 billion, including a turnkey project for relocating the wholesale produce market for southeastern Seoul. Private sector contracts totaled ₩412 billion.

Importantly, in 2006 the Division stepped up efforts to diversify into the development side of the business. A prime example is the new K-Project, which requires GS E&C to provide architectural consulting on a hotel, department store, multiplex theater and other facilities, which will then be built by the Architecture Business Division on a site owned by the Kyungbang Group. Expansion into such new-concept development-style construction projects will enable the Division to increase the portion of “outside” projects in the portfolio and ensure stable profitability.

# Management's Discussion and Analysis (Continued)

## Housing Business Division

Demand in the housing market cooled in the wake of various measures by the Korean government to curb speculation. However, the Housing Business Division leveraged an excellent brand image, selected prime locations, and targeted high-end buyers. As a result, new orders rose twelve percent, from ₩3.14 trillion in 2005 to over ₩3.5 trillion in 2006. The Division won the most redevelopment projects of any domestic builder during 2006, providing the foundation for solid growth amid adverse market conditions. Moreover, the order backlog at year's end was just under ₩7.85 trillion, up thirty-one percent from the previous term.

Projects in the housing sector are only classified as "new orders received" after the government has granted permission for construction to begin. The volume of "provisional order backlogs" (where the contracts have been signed but await government approval) stood at ₩18.5 trillion at the end of 2006, a thirty-eight percent increase over the ₩13.4 trillion figure posted the year before. The new order backlog combined with the pending orders amounts to ₩26.3 trillion in future business for the Division.

## Sales Revenue

Sales revenue growth was solid, from over ₩5.63 trillion in 2005 to more than ₩5.8 trillion in 2006, on the strength of a balanced performance among the five business divisions. As a result, GS E&C managed to achieve the highest sales total among all Korean builders during a period of overall market contraction. The Korean government issued fewer contracts, adversely affecting the Civil Engineering and Environment Divisions. However, that falloff was more than offset by increased projects overseas and higher sales in the domestic housing sector.

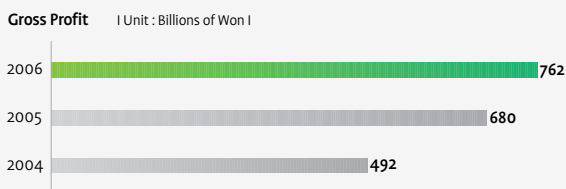
Breaking down the sales total by business division, Civil Engineering recorded ₩714 billion and Environment posted ₩257 billion, both down somewhat year on year. On the other hand, the Plant Business Division saw sales rise forty percent year on year to more than ₩1.5 trillion, as overseas projects proceeded on schedule. The Architecture Business Division adjusted downward the amount of sales revenue put on the books for large-scale projects, reducing the sales revenue total to just under ₩1.6 trillion for the year. Despite an unstable domestic housing market, the Housing Business Division proceeded with redevelopment and reconstruction projects to boost annual sales twenty-eight percent, from almost ₩1.35 trillion in 2005 to better than ₩1.72 trillion in 2006.

## Profits

### Gross Profit

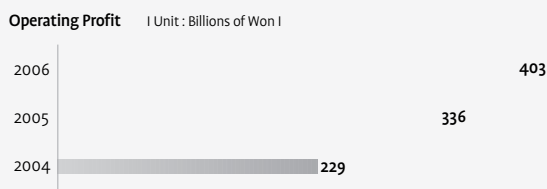
The company strove to cut costs under the "value growth through cost innovation" guideline. The effort paid off with gross profit reaching ₩762 billion in 2006, a twelve percent gain from the ₩680 billion figure for 2005, despite intensifying competition and a worsening business environment. The gross profit margin, meanwhile, improved from 12.1% to 13.3% over the same period. Importantly, an improved cost-to-sales ratio for all five business divisions drove up the profit margin, thereby boosting profitability.

The total construction cost for 2006 breaks down as fifty percent for subcontractors, thirty-two percent for materials and eighteen percent for land and other expenses, as compared to a 59:37:14 cost configuration for the previous year. The changes reflect efforts to reduce subcontractor costs and shorten project times while increasing the sales of plant projects, which have relatively high material costs.



### Operating Profit

Operating profit rose twenty percent, from ₩336 billion in 2005 to ₩403 billion a year later, while operating profit margin improved from six to seven percent during the same period. However, selling and administrative expenses also rose from ₩344 billion to ₩359 billion as a result of new investments for sustained growth; activities to promote turnkey, infrastructure and development projects; additional hiring and higher salaries; and fees paid to develop the TPMS and other IT systems. In the future, the rate of S&A expense growth should slow relative to the overall growth of the company, enabling operating profit to continue rising.



## Ordinary Profit

Ordinary profit totaled ₩544 billion in 2006, a forty-eight percent increase over the ₩367 billion posted a year earlier. The non-operating balance also surged ₩109 billion, from ₩31 billion in 2005 to ₩140 billion the following year. Non-operating income totaled ₩200 billion in 2006, as opposed to ₩108 billion the previous year, while non-operating losses for 2006 came to ₩60 billion, down ₩17 billion from the year before. The details behind these changes are as follows:

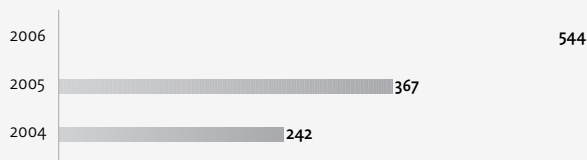
First, the company generated ₩16.5 billion by selling off LG CNS shares that had been held as saleable securities.

Second, an equity method is now being applied to invested corporations in which the company has a stake of twenty percent or more. As a result, a gain of ₩27 billion was realized from the rising profitability of invested equity assets at overseas construction contractors and subsidiaries.

Third, a strong net cash flow and high credit rating improved interest revenue by ₩16 billion.

Fourth, ongoing efforts to hedge against foreign exchange risk have included the use of foreign exchange rate risk insurance and forward transactions, which yielded ₩53 billion in non-operating income during 2006. The Exchange Rate Management Committee, formed in 2004, has minimized risk from exchange rate fluctuation and eventually aims to achieve a 100% hedge against exposure to exchange rate risks.

Ordinary Profit | Unit : Billions of Won |



## Financial Position

### Cash Flow

Cash and cash equivalents increased from ₩361 billion at the end of 2005 to ₩537 billion a year later. The changes in cash flow are detailed by activity type as follows:

First, operating cash flow totaled ₩518 billion. Contributing factors included ₩387 billion in net profit, ₩93 billion in non-cash income and expenses, and ₩111 billion in cash inflow resulting from changes in operating assets and liabilities. In addition, steady sales growth boosted notes receivable, which in turn increased trade accounts and notes receivable by ₩327 billion year on year.

Second, cash flow from investment activities generated a cash

inflow of ₩256 billion. These activities included land purchases for future development projects and increased payments for housing project loans.

Third, cash flow from financing activities fell by ₩159 billion during the year. A cash inflow of ₩7 billion was generated by the disposal of treasury stocks to pay bonuses, while the sale of memberships to a Jeju Island resort brought an additional ₩105 billion inflow of cash. On the other hand, the repayment of short-term borrowings caused a ₩142 billion cash outflow, and ₩70 billion was paid out in dividends.

### Dividends and Investments

Management decided to increase the dividend per share, which was ₩1,400 for 2005, to ₩1,550 for 2006. This raised the total dividend payout from ₩62 billion to ₩70 billion.

After distributing some profits in the form of dividends, the company invests most of the retained earnings in highly profitable projects such as apartment complexes on company owned land, PFI projects and development projects. Such investments help to elevate shareholders' future value.

In 2006, a total of ₩247 billion was invested in such activities, an increase of sixty-six percent compared to the previous year. The company plans to invest ₩314 billion in 2007 in order to step up involvement in apartment complexes on company owned land and PFI projects.

### Borrowings

Borrowings totaled ₩143 billion at the end of 2006, which was ₩65 billion less than a year earlier. The drop was mainly due to deep cuts in short-term borrowings related to trade such as usance L/Cs and export financing from Korea Exim Bank. Most of the current borrowings are long term, and corporate bonds, which total ₩50 billion, will mature in 2007.

### Equity

The company had two hundred million authorized stocks as of December 31, 2006. All the issued shares, which number fifty-one million, are common stocks; no preferred stocks, convertible bonds or bonds with warrant have been issued. Chairman Chang-Soo Huh and other members of the Huh family are the major shareholders, with 30.4% (15,496,248 shares) of the total shares issued. An additional 2% (1,109,831 shares) are in the form of treasury stock or part of the employee stock sharing program. Foreign investors own 50.6% of the total shares issued.