Management's Discussion and Analysis

Construction Market

2007 Review & 2008 Outlook

1. Domestic Construction Orders

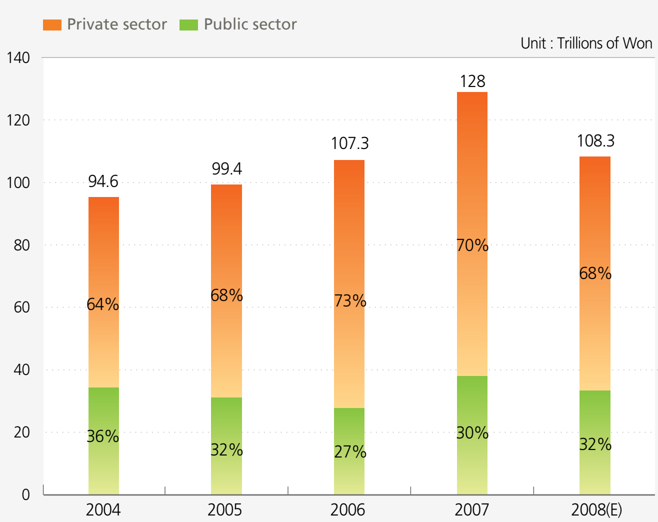
2007

New contracts in Korea in 2008 totaled ₩128 trillion, which was much higher than the original forecast of ₩96 trillion. The increase is due to the early start of many private sector housing projects to avoid the application of the presale price ceiling. Thus, the volume of housing contracts in the private sector did not grow as small as expected. At the same time, government contracts were implemented ahead of schedule and privately funded projects orders were robust.

Civil engineering projects, which represented about 70% of all government contracts, increased with the government's early implementation. Public housing construction also saw major growth.

Non-government civil engineering projects were up with the surge in privately funded projects. Private sector redevelopment projects were launched before the Housing Act amendment, while non-housing construction orders rose with Korea's economic recovery.

Construct Amount



Source: CERIK

2008

The Construction & Economy Research Institute of Korea (CERIK) predicts that new domestic construction orders will amount to ₩108.3 trillion in 2008, down from the previous year's figure. Orders related to the government's ambitious Balanced National Development Project will begin in earnest. Moreover, orders will be forthcoming for the second round of "new towns," as well as for delayed turnkey projects and projects awarded to the lowest bidder. By contrast, the volume of private sector housing orders that receive government permission will fall with the enforcement of the presale price ceiling.

The government will offer site preparation and basic infrastructure contracts for massive state-sponsored projects that include the Multifunctional Administrative City, "innovation" cities, "enterprise" cities and second-phase "new towns." In addition, turnkey and lowest-bidder projects that were deferred until 2008 will add to the public sector project total.

Meanwhile, the volume of new housing orders on privately owned land will fall with the enforcement of the presale price ceiling. The scale of available BTL contracts will also shrink. These trends will be countered by an increase in building construction and other non-housing projects.

2. Housing Market

2007

The effects of the Roh Moo-Hyun administration's policies to curb real estate speculation were fully felt in 2007. Increased transfer and property taxes helped to reduce demand regionally. In addition, tighter regulations on home loans have contributed to the falling demand. Enactment of the price threshold on new units and the subscription points system also increased the number of home purchases that were either delayed or indefinitely postponed. On the other hand, the government took steps to stimulate the stagnant real estate market outside the Greater Seoul Area. Some wards and cities were removed from a list of areas designated as housing speculation zones, and a plan was enacted to reduce the number of units that remain unsold in advance of construction.

2007 Real Estate Policy Initiatives by the Roh Moo-hyun Government

Promulgation Date	List of the Policy
January 11	Presale price ceiling, greater disclosure of construction costs, extended period before resale of pre-sold units, subscription points system
January 31	Increased supply in long-term rental homes, greater financial support for lower-class homebuyers
September 20	Removal of 12 areas (Joong-gu and Seo-gu in Daejeon, and Gumi city North Gyeongsang Province among them) from the housing speculation zone list

Meanwhile, construction companies began vigorously to pre-sell apartments before the price ceiling was imposed. The number of unsold units soared toward the end of the year as demand for homes fell.

2008

Expectations are high that the newly elected administration will ease real estate restrictions in the coming year. Yet, the regulations that were passed under the previous government are now part of law. A major overhaul is needed rather than partial amendments. Most analysts believe that tangible changes will be few in the short term.

However, the lackluster real estate market could adversely affect the real economy in Korea's provincial areas during the first half of 2008. If that happens, the government would be prompted to expedite changes to the current real estate policy.

Concerning demand, market analysts are maintaining a wait-and-see attitude while expecting it to contract further. The government's tight regulations governing housing loans and the increased interest rates in 2007 detract from purchasing power. Therefore, the effects of an artificial government policy will lower demand in 2008, and the research institutions believe effort will be required to bring it back within normal market forces.

On the supply side, construction companies offered a massive volume of units for presale during the second half of 2007, and the unsold units have increased. Therefore, they will be forced to adjust the timing of new presale offerings. Presale unit availability in the Greater Seoul Area will only increase in the coming year for apartments to be built on public land such as the second-phase "new towns".

3. Overseas Construction Orders

2007

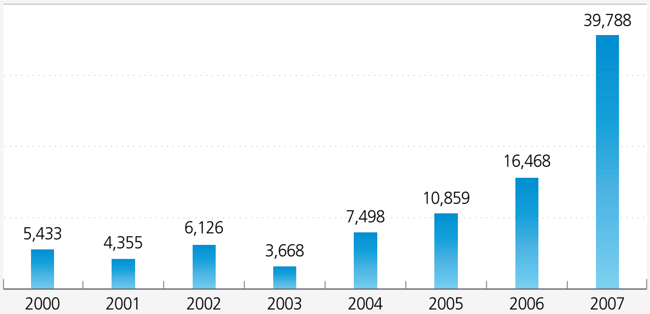
Korean companies performed their first construction contracts outside the country in 1965. In 2007, a total of 290 Korean construction companies won 619 orders, worth US$39.8 billion in 76 countries, an increase of 142% from 2006. This was also the first year on record that overseas orders surpassed US$30 billion.

Middle East projects, which were mainly plants, totaled US$22.8 billion. In Asia, Korean companies were awarded contracts for large-scale projects involving plants, civil works, building and housing. Overseas construction activity was robust overall in 2007.

Three key features can be identified regarding the overseas orders received by Korean companies during 2007. First, the persistently high oil prices drove up demand for large-scale plant projects in the oil producing countries of the Middle East. Second, recovery of

Recent Overseas Construction Orders

Unit : Millions of US dollars



Recent Overseas Construction Orders

Unit : Millions of US dollars

	2005	2006	2007
Total	10,859	16,468	39,788
Middle East	6,445 (59.4%)	9,530 (57.9%)	22,801(57.3%)
Asia	2,611 (24.0%)	4,046 (24.5%)	12,849(32.3%)
Other	1,803 (16.6%)	2,892 (17.6%)	4,138(10.4%)

the Asian construction market brought a surge in new orders. Third, real estate development projects became prevalent in both the Middle East and Asia, allowing both large construction companies and smaller ones to work outside Korea.

2008

The outlook is bright for overseas orders in 2008. Some even predict that Korean companies will receive US$40 billion worth of new contracts for the first time. The overall size of the overseas construction market is expected to grow to US$795 billion in 2008, providing ample opportunities for Korean builders. To achieve the new record, they are expected to engage in aggressive marketing as well as conclude contracts currently under negotiation. In fact, Korean companies can achieve at least US$40 billion in new contracts simply by winning 5% of all the new work that will be available around the world.

Conversely, the outlook for the Korean construction market is dim, with new orders likely to total less than US$30 billion. Potential opportunities will diminish for highly capable domestic construction companies. They are expected to confine themselves to finishing up current projects while only accepting the most profitable new contracts. Therefore, their overall growth will be minimal despite their continued expansion overseas.

2008 Overseas Construction Market and International Oil Price

	Minimum	Average	Maximum
International Oil Price	US$80/bbl	US$85/bbl	US$105/bbl
Overseas Construction Market	US$606B	US$644B	US$795B

Summary of Operations

Continued Quantitative Growth

The Korean government's anti-speculation policy continued to restrain construction activity in 2007 as it had the year before. However, GS Engineering & Construction managed to win a record ₩10.6 trillion in new orders thanks to a well-balanced portfolio spanning civil engineering, plants, environmental facilities, buildings and housing; sound finances and strong competitiveness. Sales also topped ₩6 trillion for the year. Both of these figures were the highest among all of Korea's construction companies. Also, *Engineering News Record* magazine ranked GS E&C 1st in Korea and 31st among the top 225 global contractors in 2007. These achievements satisfied the market's expectations for quantitative growth amid adverse market conditions. They also reaffirmed the potential for GS E&C to keep growing in the future. Thus, management expects new orders to reach ₩12.2 trillion and sales to total ₩6.6 trillion in 2008.

Rapid Expansion Overseas

The total value of new overseas orders, led by plant projects, surged for the second straight year. GS Engineering & Construction was awarded more than ₩3.86 trillion worth of new contracts outside Korea in 2007, a 116% jump from the almost ₩1.79 trillion figure posted a year earlier.

To diversify the portfolio, GS E&C bid on and won a linear alkyl benzene plant in Egypt in 2006. The company then received a US$1.95 billion plant project in Egypt in 2007, the single largest contract ever for a Korean construction company. Now, the groundwork has been laid for GS E&C to advance further into the African plant market.

The overseas plant projects have mainly been related to oil, gas and petrochemicals areas where GS E&C has enjoyed great success. Thus risks associated with project execution have been reduced. Along with the increased volume of new orders, the company is focusing on profitability and will be careful to bid only on quality projects in the days ahead. Meanwhile, GS Engineering & construction obtained permission to invest in three Vietnamese development projects in 2007. These include a BT project in Ho Chi Minh City, a massive housing development in Nha Be, and a resort in Cu Chi. The purchase of land in Cambodia was also finalized in 2007. Therefore, the company is ready to go forward on development projects that will become future growth drivers.

Improved Profitability

In the past quantitative growth was put ahead of profitable growth. Corporate competencies were focused on winning new orders, and the volume increased significantly as a result. Then in

2006, the company instituted a cost reduction campaign aimed at growing value. The drive for "quality growth" included the introduction of the Total Project Management System (TPMS), a working level committee to ascertain project profitability prior to bidding, and a companywide campaign to reduce sales and administrative expenses. The efforts paid off, with a gross profit margin of 14.3%, operating profit of 7.4%, and ordinary profit of 9.4%. The TPMS was extended to the construction sites in 2006. It has played a pivotal role in shortening processes and project times, lowering costs, and reducing waste from unnecessary delays and expenses.

Operation Results

Orders Received

New orders in 2007 rose 17% year on year to surpass ₩10.63 trillion. This growth continues to lead the Korean construction industry despite a contraction in construction activity. The Plant and Housing Business Divisions posted the highest increases in new orders. The volume of plant contracts surged despite a slowdown in public projects in Korea. Most of the new plant orders came from the Middle East and North Africa. Meanwhile, the domestic housing market was unsettled by the government's anti-speculation policy, but new orders for housing continued to rise nonetheless.

In accounting, GS E&C classifies newly received housing projects as either "new contracts" or "provisional contracts." 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 ₩19.7trillion, while pending contracts totaled ₩17.5 trillion, for a grand total of ₩37.2 trillion at the end of 2007. Based on 2007 sales, this is enough work to keep the company operating at full capacity for six years.

Civil Engineering Business Division

The civil engineering business environment was difficult in 2007, but the Civil Engineering Business Division leveraged its excellent technical expertise and sales organization to bolster the capability to win new government contracts. The focus was on privately funded infrastructure projects and turnkey projects, and the volume of new orders rose 41% over 2006 to reach ₩857 billion. Sales also surged 11% year on year to ₩796 billion, thanks to stronger revenue from the Seoul Beltway Project. The order backlog for the Division at year's end exceeded ₩2.41 trillion, or 11% of the company total.

Plant Business Division

The Plant Business Division received more than ₩3.73 trillion in new orders, which was some 50% higher than the original target of ₩2.47 trillion. Efforts to diversify outside the Middle East resulted in a linear alkyl benzene (LAB) plant project in Egypt in 2006. This laid the groundwork for greater inroads into the African plant market, and helped the company to win a US$1.95 billion hydrocracker project in Egypt in 2007. This was the highlight of the year for the Division: the most expensive plant project ever for both GS E&C and the Korean construction industry as a whole.

Sales of just under ₩2 trillion were posted for 2007, boosted by the second heavy oil upgrading (HOU) facilities now being built for GS Caltex.

Environment Business Division

The Environment Business Division received a total of ₩294 billion in new orders in 2007, lower than the previous year because of delayed government tenders. However, the Division was awarded a diverse range of projects, including solid waste processing, incineration, advanced water treatment and sewage treatment, to retain a leading position in the Korean environmental sector. Moreover, the order backlog at year's end totaled ₩550 billion, which was higher than the figure posted a year earlier.

The Environment Business Division has acquired extensive experience and technology in the performance of projects for GS and LG 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, and is now ready to expand rapidly into water-related projects.

Architecture Business Division

The Architecture Business Division received just over ₩1.04 trillion in new orders, down from the previous year because of a sharp decline in work from LG Philips LCD and LG Electronics. Orders from these two clients totaled ₩247 billion, or 24% of the total. Although the total volume was smaller, the projects were widely varied. In the private sector, the Division was awarded the contract for the AIG Seoul International Finance Center, keeping it active the construction of very tall buildings.

The Division has been working to diversify its portfolio since 2006, resulting in the winning of projects that include the development side of the business in addition to the construction work. Expansion into the new-concept development-style construction projects will enable the Division to increase the portion of “non-group” projects in the portfolio and ensure stable profitability.

Housing Business Division

New orders rose 34% year on year to more than ₩4.7 trillion, thanks to a sharp rise in reconstruction contracts. The new order surge boosted the backlog 37% to just under ₩10.69 trillion.

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 projects” (the signed contracts await government approval) stood at ₩17.5 trillion at the end of 2007, making the combined backlog ₩28.2 trillion.

The Division has also been improving profitability by increasing the percentage of projects performed on land owned in-house. This segment rose from 6% of the total in 2006 to 17% in 2007 with the addition of the Susaek Xi and Incheon Cheongla projects. The Division will continue to purchase residential sites that are attractive to potential homebuyers in order to increase the amount of in-house apartment construction in the portfolio.

Sales Revenue

Sales revenue grew from over ₩5.74 trillion in 2006 to more than ₩6.01 trillion in 2007 thanks to balanced results among the five business divisions.

Breaking down the sales total by business division, Civil Engineering recorded ₩796 billion, up from the previous year on strong sales from infrastructure projects.

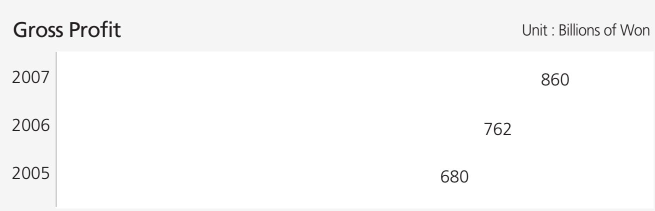
Plant saw sales rise thirty-seven percent year on year to more than ₩1.98 trillion, as the domestic HOU project and overseas plant projects proceeded on schedule. Environment sales fell to ₩214 billion and Architecture sales were also down to under ₩1.06 trillion with the ongoing reduction in “group” projects from 2006.

Despite an unstable domestic housing market, the Housing Business Division proceeded with large-scale redevelopment projects as well as projects on company owned land to boost annual sales 14%, from ₩1.72 trillion in 2006 to over ₩1.96 trillion a year later.

Profits

Gross Profit

The companywide effort to cut costs for “value growth” boosted gross profit 13%, from ₩762 billion in 2006 to ₩860 billion in 2007, despite intensifying competition and a worsening business environment. The gross profit margin also improved from 13.3% to 14.3% over the same period. Importantly, the Civil Engineering Business Division achieved a 25% margin on the Seoul Beltway Project, and cost cutting efforts raised the gross profit of the Plant Business Division’s overseas projects by three percentage points. Finally, gross profit for the Housing Business Division rose from 13.5% in 2006 to 14.3% in 2007 as a result of lower costs from use of the TPMS as well as higher sales from large-scale reconstruction projects. The rising trend is expected to continue in 2008.

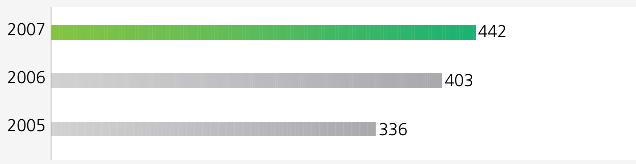


Operating Profit

Operating profit rose ten percent, from ₩403 billion in 2006 to ₩442 billion a year later, while operating profit margin improved from 7.0% to 7.4% during the same period. A higher gross margin allowed operating profit to rise even as the ratio of sales and administrative expenses to sales revenue went up. The main factors driving S&A expenses has been investments for continued growth, increased costs to perform key revenue generating projects, and additional hiring and higher salaries, In the future, the rate of S&A expanse growth should slow relative to the overall growth of the company, enabling operating profit to continue rising.

Operating Profit

Unit : Billions of Won



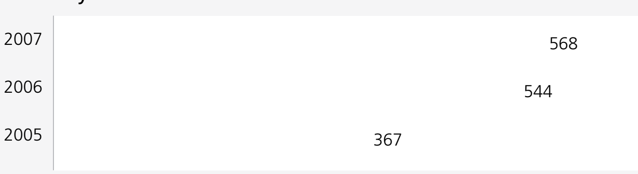
Ordinary Profit

Ordinary profit totaled ₩568 billion in 2007, a four percent increase over the ₩544 billion posted a year earlier. The non-operating balance fell from ₩140 billion to ₩126 billion during the period.

Non-operating income breaks down as follows: Interest income amounted to ₩34 billion, while gains on equity method, which went into the black in 2004, posted around ₩30 billion in 2007. Ongoing efforts to hedge against foreign exchange risk have included the use of foreign exchange rate risk insurance and forward transactions, which yielded ₩12 billion in non-operating income during 2006.

Ordinary Profit

Unit : Billions of Won



Financial Position

Cash Flow

Cash and cash equivalents dropped from ₩537 billion at the end of 2006 to ₩386 billion a year later. The changes in cash flow are detailed by activity type as follows:

First, operating cash flow totaled ₩192 billion. Contributing factors included ₩400 billion in net profit, ₩94 billion in non-cash income and expenses, and ₩686 billion in cash inflow resulting from changes in operating assets and liabilities.

Second, cash flow from investment activities generated a cash outflow of ₩277 billion. These activities included investments for future development projects and land purchases for in-house projects.

Third, cash flow from financing activities increased by ₩315 billion during the year. Inflow and outflow from short-term borrowings resulted in a ₩399 billion cash increase, and ₩78 billion was paid out in dividends.

Dividends and Investments

Management decided to increase the dividend per share, which was ₩1,550 for 2006, to ₩1,650 for 2007. This raised the total dividend payout from ₩70 billion to ₩82 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.

Borrowings

Borrowings at the end of 2007 totaled ₩463 billion, up sharply from the ₩65 billion figure posted a year earlier. These funds will mainly be used to invest in overseas development projects and land in Korea for in-house projects.

Equity

The company had two hundred million authorized stocks as of December 31, 2007. 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% of the total shares issued. An additional 2.1% are in the form of treasury stock or part of the employee stock sharing program. Foreign investors own 39.55% of the total shares issued.