

# Company Visit Note

## Heerim Architects & Engineers

- Heerim is one of Korea's leading architectural design firm, providing design services (73% of 2007 sales) and construction/project management consulting (27% of sales) for residential/non-residential construction projects. Positive industry dynamics, strategic focus on overseas markets and scale economies to drive new orders (42% CAGR 04-07) and corresponding earnings growth. The company boasts a debt-free balance sheet and above-average ROIC and ROE thanks to an asset light model and minimal reinvestment requirements.
- **2010 sales guidance of W250B rev =>3 yr 27% CAGR.** Led by increased overseas orders (50% of sales by 2010 from 11% in 2007) sales to double by 2010 to W250B from W120B in 2007 without a significant increase in headcount. Management concedes the building environment is challenging but concurrently expects operating margin to be durable at 11-12% from 10% in 2007. Mix is steadily improving as are unit contract values thanks to larger projects in the mix. Rising input costs and wage inflation are not worrisome factors. Assuming Heerim can maintain a run-rate net margin of 6-7%, net profit could compound 19-24% by 2010.
- **Cash deployment.** In addition to dividending out 30-40% of net profit, Heerim is considering buying back shares without specifying details.
- **Risks:** Prolonged global pullback and tighter financing could hurt demand for spending on res/non-res construction. New orders are lumpy and timing of awards could lead to quarterly disappointments.
- **Valuation and share price:** The stock has been a steady performer amid recent volatility, supported partly by its robust growth outlook. Based on consensus estimates, Heerim is trading on FY08-09 P/E of 9.0x and 6.5x.

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### Heerim Architects & Engineers (037440 KS), Financial data

	FY07	FY08E	FY09E	FY10E
Sales(W B)	120	171	220	250
Operating profit (W B)	12	19	26	30
Net profit (W B)	9	N/A	N/A	N/A
EPS (W)	697	N/A	N/A	N/A
EPS growth (%)	160.4%	N/A	N/A	N/A
ROE (%)	22.7	N/A	N/A	N/A
P/E (x)	13.5	N/A	N/A	N/A
P/B (x)	2.6	N/A	N/A	N/A
DPS (W)	250	N/A	N/A	N/A
Yield (%)	2.6	N/A	N/A	N/A

Source: Company.

[www.morganmarkets.com](http://www.morganmarkets.com)

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### 037440 KS, Not Covered

W9,420, Jun 16, 2008

#### One-year price performance

(Won)



Source: Datastream

#### Recent price performance

	1 Mth	3 Mths	1Yr
Absolute (%)	+8.8	-0.2	+108.0
Relative (%)	+16.7	-9.2	+109.4

Source: Quantwise

#### Company data

52-wk range (W)	10,100 – 3,960
Mkt cap. (W B)	122
Mkt cap. (US\$ MM)	117
Common shares O/S (MM)	12.9
Free float common (%)	55
Foreign ownership (%)	6.3
Avg trading value (US\$MM)	0.4
Exchange rate	W1,040/US\$1
Kospi Index	1,761
Year-end	Dec

Source: Bloomberg, Company

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## Post visit takeaways

### Company Overview

Established in 1970, Heerim is one of Korea's leading architectural and design houses in Korea. The domestic industry is fragmented with about 8,000 firms, but only about 10 firms are big enough to carry out large, complex projects. *Building Design* magazine ranked Heerim as the second largest Asian architecture firm behind Nikken Sekki of Japan, and based on its sales of W120 billion in 2007, Heerim would be ranked in the top 10 globally. Heerim competes on the quality of its design and consulting services and competitive pricing. These factors combined with a growing portfolio of landmark projects have enabled Heerim to gain more overseas work (first overseas project award in 2000). While the company does not face capacity constraints, it plans to hire about 100 people per annum in the foreseeable future to attain its growth objectives. In contrast to plant engineers, the supply of architects is relatively more abundant according to the company. The company reported 960 employees as of 1Q08, up from 891 as of Dec-07 and 790 in Dec-06. CEO Mr. Jung Young Kyun is the largest shareholder with a 25.7% stake, while other BOD members own a collective 15.9% stake. The largest domestic institutional investor is Korea's National Pension Service with a 6.7% stake. Foreign ownership is 6.3%, down slightly from a peak of 6.6% on June 10.

### Earnings outlook

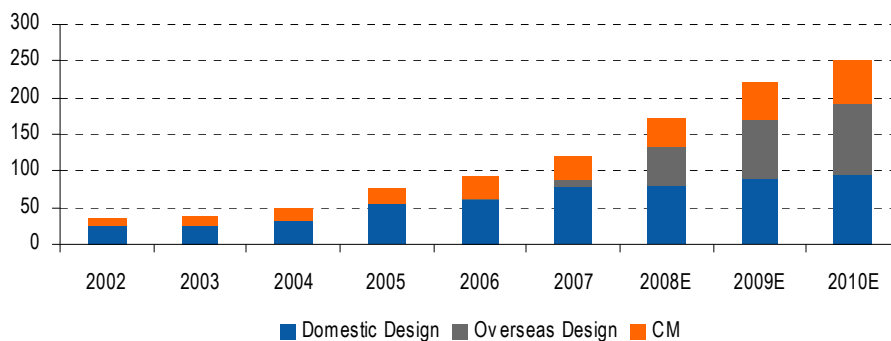
Revenues are comprised of design services and construction management services. Design revenues comprise business planning, architecture and interiors, landscape and remodeling, urban design & planning and project coordinating planning. Clients are mainly E&C companies and project owners, which are both private and public entities. To date, construction management services is purely a domestic business. The work usually originates from government entities and includes planning and feasibility study, contract and bid management, design & construction management, design and construction audit and design change management/final inspection.

As a % of total construction costs, design accounts for 4-7% of total construction cost of a building. Revenues are recognized based on % of completion method, and profitability of a project is usually back-end loaded. In terms of cash flow, Heerim typically receives an initial payment (10-20% of contract value) followed by two interim payments and a final payment (5-10%). Most of Heerim's domestic and overseas projects are awarded in one of three ways: "competition" where design is the key criteria, "turnkey" where bids are jointly tendered with consortium partners and "pre-negotiated contracts". Projects awarded on the basis of design (competition) are the most profitable. Without specifying, the company tries to abide by internal margin thresholds or IRR when bidding, and estimates that it is successful in 30-40% of all domestic bids and 50-60% for overseas projects.

Labor and wages account for the majority of operating costs. Of which 45% is direct labor and 55% is outsourced (landscaping, structure, civil engineering). Heerim believes it has a good record of accurately estimating project costs and has not experienced significant cost overruns. Owing to a growing % of larger projects, increased overseas orders (US\$ based) and scale economies associated with increased sales, Heerim expects margins to be durable in the coming years.

Despite the growing macro headwinds, Heerim believes the long-term order outlook remains positive given its increased recognition in overseas building markets and pipeline of urban renewal projects in Seoul and other large cities. Figure 1 illustrates that while domestic design work will anchor sales, growth will be driven largely by overseas design work mostly in developing countries. It's noteworthy that the company received its first order from the U.S. on June 16. Though the contract is only W409 million, it is a positive development and marks Heerim's efforts to expand into more developed countries.

**Figure 1: Heerim: Sales guidance**  
(Won in billion)



Source: Company

### Financial position

Heerim boasts a strong, debt-free balance sheet. Heerim has minimal reinvestment and capex requirements specific to its asset light operating model. Employee headcount has more than doubled from 400 in 2002 to 891 in 2007 and resulted in increased scale. In terms of orders per employee, the number has increased from W140 million/employee in 2002 to W239 million/employee in 2007. In terms of sales, the number has increased from W85 million/employee in 2002 to W135 million/employee in 2007. Heerim plans to hire about more 100 architects and designers in the near future.

In addition to maintaining a dividend payout of 30-40% of net profit, Heerim is considering buying back shares without specifying details.

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Revised December 31, 2004.

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## Heerim Architects & Engineers: Financial summary

(Won in billion, year-end December)

<b>Profit and Loss statement</b>	<b>FY04</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07</b>	<b>Balance sheet</b>	<b>FY04</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07</b>
<b>Net Sales</b>	<b>50</b>	<b>76</b>	<b>91</b>	<b>120</b>	<b>Current Assets</b>	<b>18</b>	<b>19</b>	<b>17</b>	<b>35</b>
Cost of Sales	42	65	77	98	Cash & equivalents	9	3	4	10
<b>Gross Profit</b>	<b>8</b>	<b>11</b>	<b>14</b>	<b>22</b>	Receivables	7	10	10	20
margin (%)	16.1%	14.5%	15.6%	18.7%	Inventory	0	0	0	0
SG&A	4	5	10	10	Others	2	6	3	5
<b>EBITDA</b>	<b>5</b>	<b>7</b>	<b>6</b>	<b>14</b>	<b>Fixed Assets</b>	<b>13</b>	<b>16</b>	<b>21</b>	<b>22</b>
margin (%)	9.8%	9.4%	6.7%	11.9%	Investment Assets	4	3	4	4
<b>Operating Profit</b>	<b>4</b>	<b>6</b>	<b>5</b>	<b>12</b>	Tangible Assets	8	11	8	9
margin (%)	8.1%	8.0%	5.2%	10.3%	Others	1	2	8	9
Non-operating items	1	(1)	(1)	0	<b>Total Assets</b>	<b>30</b>	<b>35</b>	<b>38</b>	<b>57</b>
Interest income	1	0	0	0	<b>Current Liabilities</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>9</b>
Interest expense	0	0	0	0	Payables	0	0	0	0
FX transaction	0	0	0	0	Short-term Debts	0	0	0	0
FX translation	0	0	0	(0)	Others	2	3	4	9
Gain on equity method	0	0	0	0	<b>Non-current Liabilities</b>	<b>2</b>	<b>1</b>	<b>1</b>	<b>2</b>
Others	(0)	(1)	(1)	0	Long-term Debts	0	0	0	0
<b>Pre-tax Profit</b>	<b>5</b>	<b>6</b>	<b>4</b>	<b>13</b>	Others	2	1	1	2
margin (%)	9.2%	7.3%	4.6%	10.7%	<b>Total Liabilities</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>11</b>
Income Taxes	(1)	(1)	(1)	(4)	Paid-in Capital	5	5	5	6
<b>Net profit</b>	<b>4</b>	<b>5</b>	<b>3</b>	<b>9</b>	<b>Capital Surplus</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>6</b>
margin (%)	11.1%	8.3%	5.3%	14.0%	Retained Earnings	20	24	26	33
<b>Adjusted EPS (Won)</b>	<b>280</b>	<b>373</b>	<b>268</b>	<b>697</b>	<b>Shareholders' Equity</b>	<b>27</b>	<b>31</b>	<b>33</b>	<b>46</b>
<b>Cash flow</b>	<b>FY04</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07</b>	<b>Ratio Analysis</b>	<b>FY04</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07</b>
<b>Operational cash flow</b>	<b>4</b>	<b>4</b>	<b>7</b>	<b>7</b>	<b>Growth Ratios</b>				
Net Profit	4	5	3	9	Sales growth %	33.5%	53.3%	20.3%	31.3%
D&A	1	1	1	2	Operating profit growth %	385.8%	51.4%	-22.1%	162.0%
Severance provision	0	0	1	1	Net profit growth %	68.7%	15.0%	-22.7%	243.6%
FX gains/losses	0	0	0	0	EPS growth %	168.7%	32.8%	-28.2%	160.4%
Chg in working capital	(0)	(3)	(2)	(5)	<b>Profitability Ratios</b>				
Others	0	1	4	0	Gross margin %	16.1%	14.5%	15.6%	18.7%
<b>Investment cash flow</b>	<b>(4)</b>	<b>(5)</b>	<b>(3)</b>	<b>(8)</b>	EBITDA margin %	9.8%	9.4%	6.7%	11.9%
Capex	(1)	(4)	(2)	(2)	Operating margin %	8.1%	8.0%	5.2%	10.3%
Disposal of tangible assets	0	0	0	0	Net margin %	11.1%	8.3%	5.3%	14.0%
Chg of Intangible assets	(0)	0	(0)	(0)	<b>Stability Ratios</b>				
Chg of Investment assets	(1)	0	(1)	(0)	Total debt to equity %	0.0%	0.0%	0.0%	0.0%
Others	(2)	(1)	(1)	(6)	Net debt to equity %	-31.9%	-9.2%	-12.9%	-21.9%
<b>Financing cash flow</b>	<b>(0)</b>	<b>(0)</b>	<b>(2)</b>	<b>4</b>	Current ratio %	981.5%	603.2%	465.3%	378.2%
Chg in ST & LT debts	0	0	0	0	Interest coverage	N/M	N/M	N/M	N/M
Change in Bonds	0	0	0	0	<b>Performance Ratios</b>				
Right Issue	0	0	0	0	ROE %	14.4%	16.6%	10.8%	22.7%
Dividend	(0)	(1)	(1)	(2)	ROIC %	22.4%	27.1%	16.9%	33.2%
Others	(0)	0	(0)	1	<b>Per Share Ratios</b>				
<b>Net cash flow</b>	<b>0</b>	<b>(1)</b>	<b>2</b>	<b>3</b>	Adjusted EPS(Won)	280	373	268	697
Cash at beginning	2	2	1	3	BVPS (Won)	2,093	2,408	2,568	3,569
Cash at end	2	1	3	6	DPS (Won)	85	127	169	250

Source: Company