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27 August 2009

Korea

Miscellaneous

Reuters 037440.KQ
Bloomberg 037440 KQ

Priced on 26 August 2009

Korea Kospi @ 1,614.1

12M hi/lo 13,300/5,779 won

12M price target 15,700 won

±% potential +34%

Target set on

Shares in issue 12.9m

Free float (est.) 59.6%

Market cap US\$126m

3M average daily volume

1.8bn won (US\$1.5m)

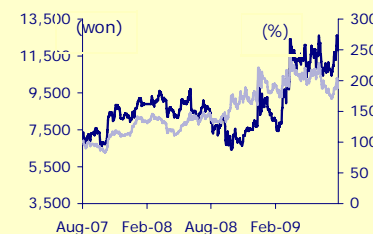
Major shareholders

Chung Young Kyun and related
40.4%

Foreign s'holding 10.4%

Stock performance (%)

	1M	3M	12M
Absolute	9.9	8.8	39.1
Relative	2.3	(7.5)	28.4
Abs (US\$)	10.2	10.4	21.7



— Heerim A&P (LHS)
— Rel to Kospi (RHS)

Source: Bloomberg

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Better buy design

Heerim is the no.1 architectural design firm in Korea with highest market share of 10%. The rather dull architectural look of Korea is changing as the people and the government started to appreciate design works and Heerim will benefit from such perception change and increasing mega development projects driven by the government. Having delivered 20% cagr in revenue over more than 10 years, we expect 13.2% cagr over 08-11CL through continued active overseas works and dominant domestic market position. Heerim deserves a premium to its current 10.5x 10PE due to its strong growth, high dividend pay out and ROE. We initiate with a BUY and a 15,700won target price at 14x10PE for 34% upside.

Shifting design paradigm, big room to grow

Architectural design in Korea was rather neglected as the priority was to get the construction work done fast during the industrialization in the 70s to boost the economy. However, the government is now determined to change the overall "looks" of the nation by enforcing architectural regulations and emphasizing design in mega development projects. Green building and construction management also adds a niche to Heerim's business portfolio.

Market dominator

With no.1 market share of 10% in domestic architectural design, the biggest overseas exposure among peers, solid client base, great track record, largest headcount, and early investment in green building, Heerim will be leading such paradigm shift in Korea as it will consolidate the fragmented market and benefit the big players like Heerim.

Growth to continue

Heerim achieved topline growth of 20.8% from 96 to 08 and we expect 13.2% cagr over 08 to 11CL from favourable demand in domestic and overseas. Overseas sales jumped from 0 in 06 to 22% in 08 due to the orders received in last couple of years and it will continue to contribute at similar portion. Slight OP margin improvement to 10.8% in 2011 from current 10.1% is expected due to economy of scale and relatively higher overseas margin.

Buy with 34% upside

Target price of 15,700won is based on 14x10CL PE, which is consistent with our DCF valuation and conservative to the theoretical PE calculation. We have factored in the 15bnwon convertible bond issued in Jul09 to our valuation but consensus doesn't seem to. We are excited about the structural story and would see the likely need to lower the 09 guidance as a buying opportunity.

Financials

Year to 31 Dec	07A	08A	09CL	10CL	11CL
Revenue (bn won)	120.13	155.84	174.79	206.27	226.19
Net profit (bn won)	8.99	15.79	13.61	16.07	18.40
EPS (won)	626.9	1,100.7	948.6	1,119.8	1,282.5
EPS (% YoY)	160.4	75.5	(13.8)	18.0	14.5
PEx (@11,700 won)	18.7	10.6	12.3	10.4	9.1
Dividend yield (%)	4.2	2.7	2.2	2.6	2.7
FCF yield (%)	2.7	(4.3)	(1.2)	3.4	7.4
ROAE (%)	22.7	30.8	22.1	22.1	19.8
Price/book (x)	1.6	2.7	1.9	1.7	1.6
Net gearing (%)	(23)	(10)	1	(2)	(23)

Source: CLSA Asia-Pacific Markets

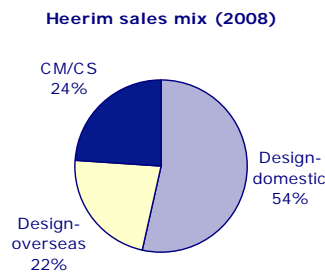
Perception on design is changing in Korea

Shifting design paradigm

Architectural design in Korea was rather neglected compared to the actual construction work during the industrialization in the 70s as the goal was to boost the economy as fast as possible through construction works. Home buyers didn't care about the design of the apartment as long as there was a place to live in. However, people became more conscious about design as standard of living improved and the government is determined to change the overall "looks" of the nation by enforcing laws and emphasizing design in mega development projects. Buildings are getting taller, bigger, and more complex and such projects can only be designed by large companies. Heerim, which has 76% of sales coming from architectural design, will benefit from such change as it has no.1 market share in the architectural designing space.

Figure 1

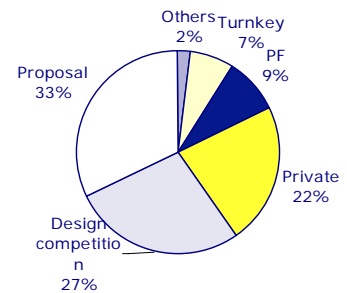
Heerim sales mix (2008)



Source: CLSA Asia-Pacific Markets

Figure 2

New orders by type



Source: CLSA Asia-Pacific Markets

Govt getting stricter on design requirements

Looks matter now, and the government thinks so too

The Seoul City has been appointed as the "2010 World Design Capital" and has been showing efforts to change the overall "design" of the city and perception of design. Starting from small examples, each district is changing the signs, lights, roads, and bins, etc. New public buildings will have to meet guidelines and laws set by the Seoul Design Committee to get permission for construction and any new residential apartments in Seoul will have to meet stricter guidelines in differentiating the height of each building. Design now makes a big difference in presale unlike the past where the price and location was the only matter.

Figure 3

Looks didn't matter in the past..



Source: CLSA Asia-Pacific Markets

Figure 4

But people want to live in a "good looking" place now



Source: HDC (the Udong project, to be completed in 2011)

Improving the looks of Seoul City

The Seoul Renaissance

Large scale, long term projects such as the “Renaissance” project which launched as a long term plan since last year is also another example of government effort to change the design works. It is made of number of districts in Seoul where design works will change. The first launched “Han River Renaissance Project” goal is to modernize the buildings, bridges and structures, etc located around the river and make the river more approachable which already shown some good accomplishments with the new swimming pool, parks and bridge lightings. Heerim is doing advisory work with the city regarding this project and could expect some more orders as the city is introducing series of Renaissance projects.

Figure 5

Renaissance project plan			
Location	Completion	Project size (trn won)	Comments
Namsan Renaissance	2013	0.2	
South West Renaissance	2020	20.3	
Han River Renaissance	2030	0.9	Heerim currently doing advisory works with the Seoul City
North East Renaissance	2018	8.0	

Source: CLSA Asia-Pacific Markets

With such government’s willingness to change the landscape of Korea with improved design and people’s change in design perception, we believe Heerim will be a major beneficiary as the government would want to work with reliable big companies. The new Seoul City Hall that is currently being reconstructed was also a project that Heerim designed, which proves company’s high profile.

Figure 6

Current image of Hanriver



Source: Hangang Project , CLSA Asia-Pacific Markets

Figure 7

Han river after the “Renaissance” development



Source: Seoul City, CLSA Asia-Pacific Markets

Government granting benefits for Green Buildings

Buildings are becoming cleaner and greener

Another paradigm shift in architectural design is that it is requiring more eco-friendly designs so that a building could save energy consumption and operate with renewable energy sources. Buildings typically consume 20% of total energy in Korea, and this accounts for 13% of Co2 emission. By investing 2-10% more cost to build a “Green Building”, it could save energy cost by roughly 10-30%.

While new public buildings are to meet higher environmental standards, the law is more focused in giving incentives to green buildings in the private side by providing subsidy, increasing plot ratio or building height, etc by maximum 5%. Also, building acquisition tax and registration tax cut of 5% to 20%

Heerim R&D for Green Building is for future growth engine

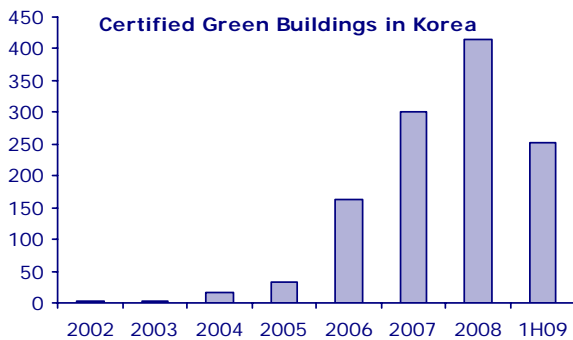
depending on the region, energy saving level, Energy Productivity Index (EPI) or the Green Building Certification is granted.

The government is trying to pass an amended Construction Act this year with higher environmental standards for building construction. Also, the "Green Growth Fundamental Law", which draft has been finalized last year on detailed standards, subsidy, process, management on green growth or investments to stimulate eco-friendly activities, is also waiting to pass the Parliament this year. Out of the 113.5trnwon budget for the "Green New Deal" set by the govt from 09-13, 25trn won is allocated to green building and bicycle road development.

With such legal changes and benefits, demand for Green Building will go up as it did in fig7. Heerim allocates 3% of sales into R&D every year which is focused in Green Building area as company sees it as the future growth engine. The highest scored Green Building in Korea, the SK Chemical Research Center, was designed by Heerim in 2008. Designing a Green Building is a high-technology aiming to save energy consumption or lower environmental impacts in many different areas such as land, transportation, energy, construction material, maintenance, interior, etc according to the law which works under a scoring system.

Figure 8

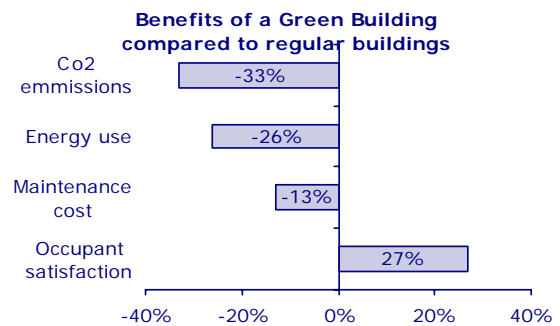
New green buildings are increasing every year



Source: MLTM, CLSA Asia-Pacific Markets

Figure 9

Why builders will go for a green building



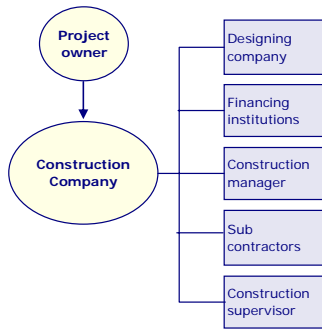
Source: Office of Applied Science of the US General Services Administration

Construction management is attractive in the long term

Heerim's Construction management and supervision division (CM/CS) accounts for 24% of revenue, and usually has thinner margin than design. The role of CM/CS is focused in regular check up or auditing of the construction process in cost, execution, workers role, etc during the construction period. A typical construction project in Korea is led by the contractor who hires subcontractors, design company, CM/CS, etc. This scheme resulted in cost overruns, high leverage, inefficiency, etc. Due to such negativities, the concept of an independent construction manager, hired by a project owner, started to make sense which is how a typical project would work in developed countries. The independent CM function will get popular in the longer term as it enhances transparency from the project planning stage to construction completion and save time and money.

Figure 10

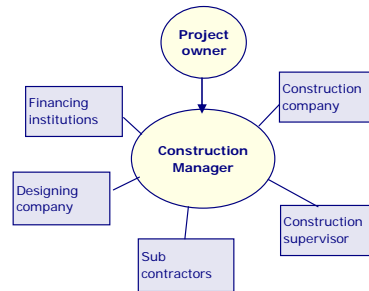
Traditional construction project structure



Source: Heerim, Hanmi Parsons, CLSA Asia-Pacific Markets

Figure 11

But a more proper structure is needed



Source: Heerim, Hanmi Parsons, CLSA Asia-Pacific Markets

Heerim dominates the market with no.1 market share

Heerim is the market dominator

With bigger emphasis put in design than before in Korean landscape, architectural design orders are getting bigger and more complex as new projects require a design of multiple buildings rather than just one. Also, green buildings require high-technology and advanced skill sets and such works can only be done by big companies like Heerim as the smaller players don't have experience or capacity, which makes the big companies more competitive.

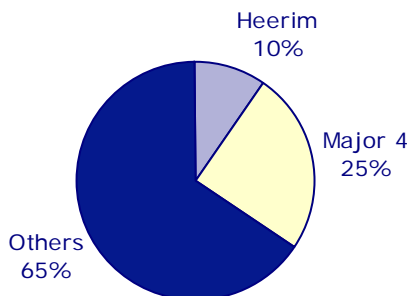
No.1 market share

Architectural design market in Korea is very fragmented having more than 7,000 architectural design companies, but the market is dominated by 5 major companies as we can see in figure 12 where they take up 35% of the market and their share of market is going up. Top players have bigger share in the large scale projects, projected to be above 80%, so the major companies will continue to benefit from increasing bigger scale projects. Heerim will lead the market paradigm change with its 10% market share position.

Figure 12

Market is dominated by top 5 design firms...

Architectural design marketshare

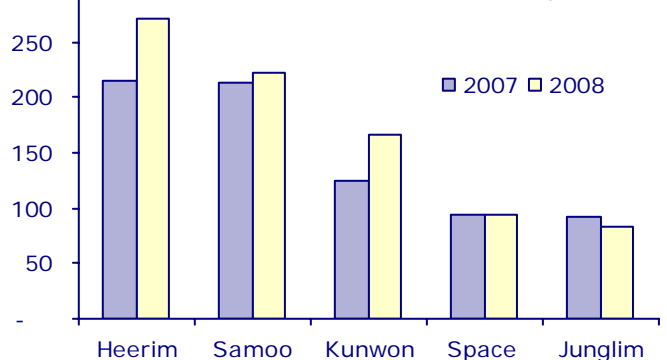


Source: Heerim, CLSA Asia-Pacific Markets

Figure 13

...and Heerim achieved the biggest order

New orders of the top5 design firms



Source: Kisline, Heerim, CLSA Asia-Pacific Markets

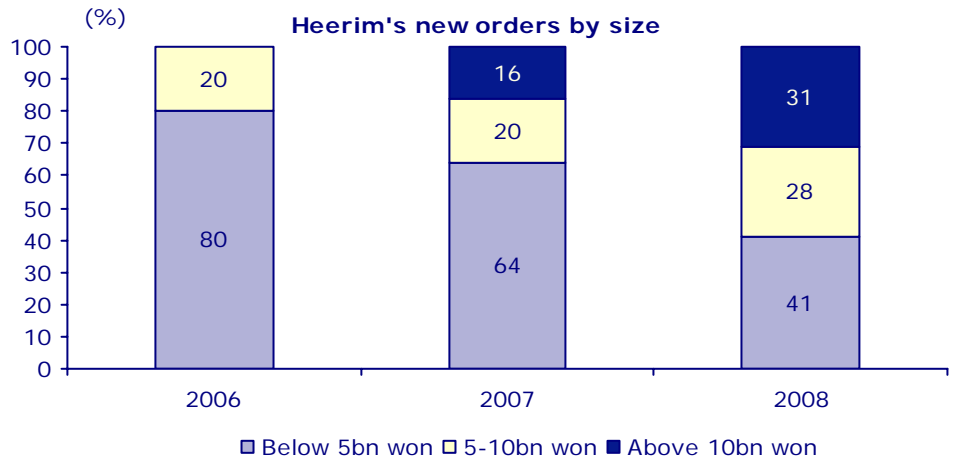
Getting bigger orders

Heerim is involved in many renowned large-scale development projects and won the most orders in past 2 years among peers as in figure 13. The recent large scale, government driven development projects that comprise of residential buildings, office buildings, hotels, shopping malls, schools, etc in

Songdo, Yongsan, and Yeoido, etc all contain high-rise, state of the art designed buildings. Heerim did multiple works in all of such areas already and we can see in figure 14 that the individual order size is increasing.

Figure 14

Order size of individual projects are getting bigger



Source: Heerim, CLSA Asia-Pacific Markets

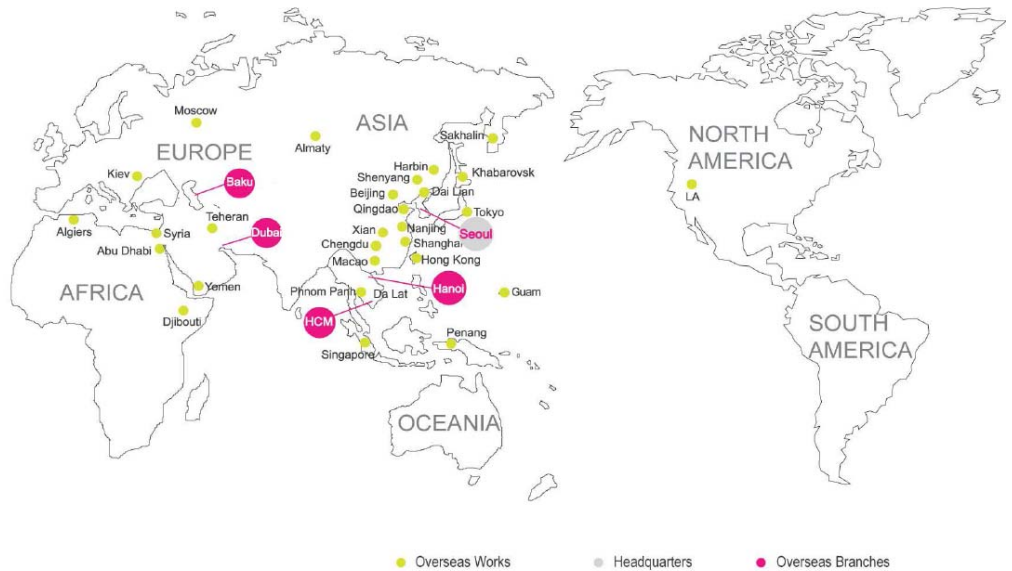
Heerim started getting orders from 07 in emerging markets

Overseas is the sweet spot

Overseas sales portion increased from 0 in early 2000 to 22% in 2008 in terms of sales. Heerim's overseas clients are mostly public government entities in emerging countries such as Azerbaijan, Vietnam, Dubai, etc.

Figure 15

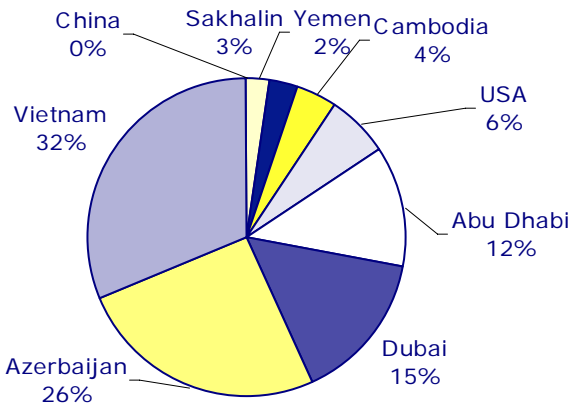
Overseas project location and offices



Source: Heerim, CLSA Asia-Pacific Markets

Figure 16

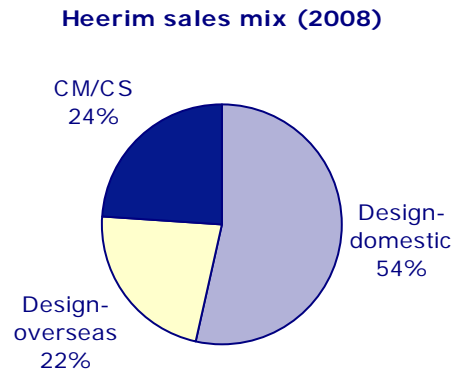
Overseas backlog mix by country (Jun09)



Source: FSS, CLSA Asia-Pacific Markets

Figure 17

Overseas is 22%



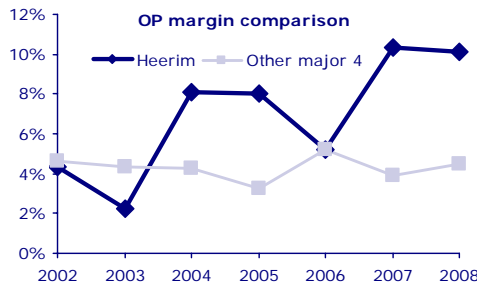
Source: Heerim, CLSA Asia-Pacific Markets

Higher margin than domestic

Usually about 2-3% of total construction cost will be allocated to design in domestic, generating less than 10% OP margin in average. However, in overseas market, design accounts for 3-7% of total cost, where margins could go above 10%. That is why Heerim saw margin uptick from 2007, achieving a double digit margin.

Figure 18

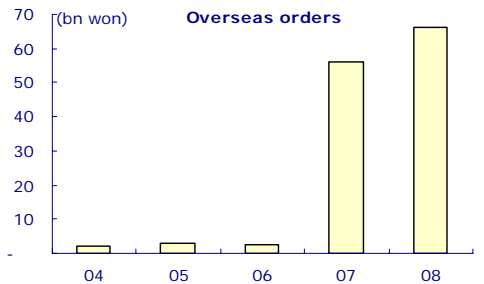
Outstanding margin compared to peers



Source: Wisenet, CLSA Asia-Pacific Markets

Figure 19

Was helped by overseas order growth



Source: Heerim, CLSA Asia-Pacific Markets

Figure 20

Heerim's "Crescent" hotel project in Azerbaijan



Source: Heerim, CLSA Asia-Pacific Markets

Figure 21

Iran Oil Ind HQ designed by Heerim



Source: Heerim, CLSA Asia-Pacific Markets

Smart move, raising the profile

Heerim was smart to enter into the overseas market because peers have much smaller overseas sales if any and usually records a high single OP margin. This drove up the profile of the company globally as well, ranking number 12 among world wide architect firms by "Building Design" magazine. Even when looking at the global competitors in figure 22, we can see that Heerim is one of the companies with biggest overseas revenue exposure. This was driven by a US educated CEO, Jung YoungKyun, and the company's strategy is to keep the overseas division as an important part of their business portfolio.

Figure 22

Heerim global ranking on "Building Design" based on fee income

2009 ranking	2008 ranking	Company	Country	Design fee (US\$m)	(KRW, \$m)	Overseas portion
1	1	Nikken Sekkei	Japan	325	HOK	44%
2	4	Aedas	UK	299	RTKL	30%
3	5	Foster & Partners	UK	280	Heerim	29%
4	3	Gensler	USA	239	Nikken Sekkei	4%
5	2	HOK	USA	226	HKS	10%
6	8	RTKL Associates	USA	186	Gensler	20%
7	7	HKS	USA	181		
8	9	Atkins	UK	167		
9	15	Perkins & Will	USA	146		
10	14	NBBJ	USA	143		
11	10	BDP International	UK	143		
12	18	Heerim Architects	Korea	133		
13		P&T	China	120		
14	11	RMJM	UK	115		
15	13	DLR Group	USA	113		
16	17	Perkins Eastman	USA	113		
17	19	Cannon Design	USA	110		
18	20	Nihon Sekkei	Japan	104		
19		Stantec Architecture	Canada	1,100		
20		Callison	USA	96		

Source: Building Design, CLSA Asia-Pacific Markets

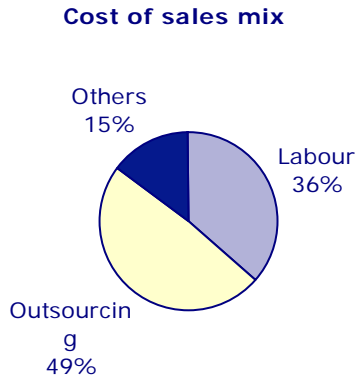
Competitive human resource and economy of scale

As a service company, the competitiveness of an architectural design company lies in human resource and Heerim has the largest number of staff of 1,050 people in the domestic industry. Heerim is the most popular place among architects to work for according to "worker.co.kr", a job searching website for construction related industries. Heerim attracts the best graduate students around the nation and has some foreign designers working in Seoul. Head count has been steadily increasing and they are benefiting from economy of scale as in figure 24. This is possible as labour is major cost factor for Heerim, accounting for 85% of total cost of sales.

Heerim is the most popular workplace in the industry, attracting competitive designers

Figure 23

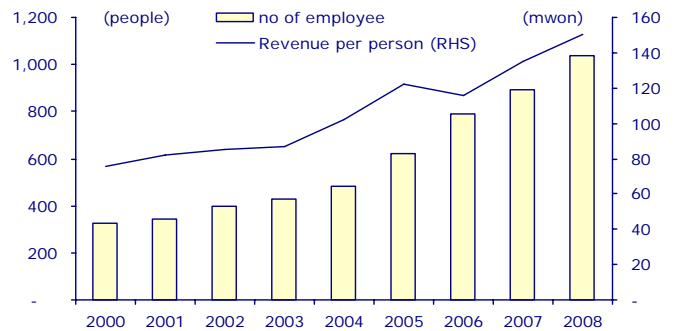
Labour is the main cost



Source: CLSA Asia-Pacific Markets

Figure 24

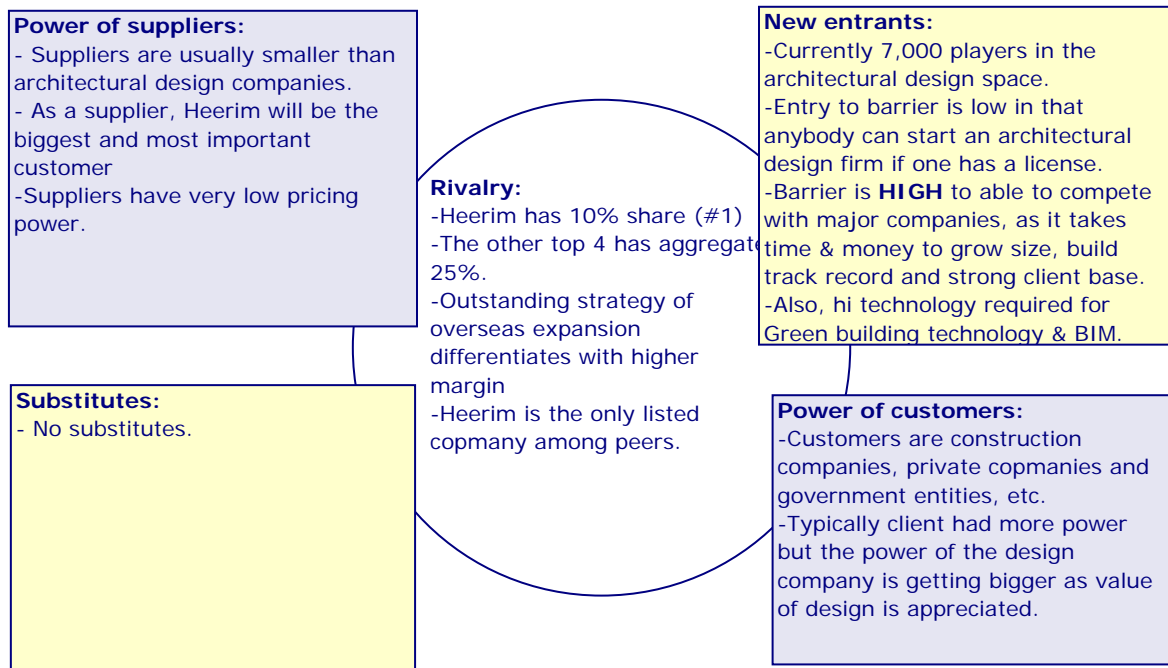
Benefiting from economy of scale



Source: FSS, CLSA Asia-Pacific Markets

Figure 25

Porter's five competitive forces applied to Heerim



Source: CLSA Asia-Pacific Markets

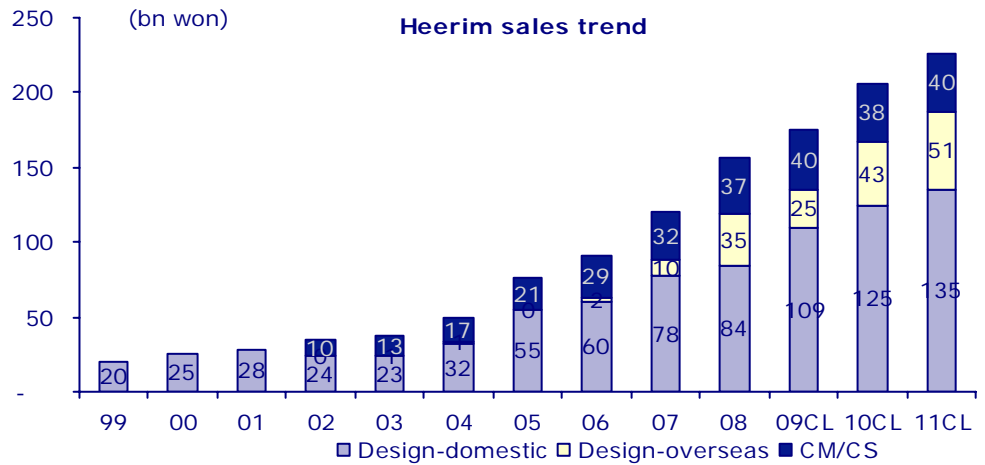
Heerim will see 13% sales growth from 08 to 11CL

Continued growth

Heerim was able to grow by Cagr 28.8% from 2002 to 2008 in revenue due to design industry growth, market share expansion and overseas order growth. The long term macro outlook is very favourable towards Heerim as Korea has big room for improvement in architectural design and we are witnessing changes and demand for better design both driven by government effort and change in perception towards design among general people. With its strong backlog of 337bn won as of Jun09, which will generate 2 years work, dominant market position, spectacular track record, increasing overseas orders, high technology in niche green market, etc, we expect Heerim to achieve 13% Cagr sales growth up to 2011 from 2008.

Figure 26

Expect 13% growth to 2013



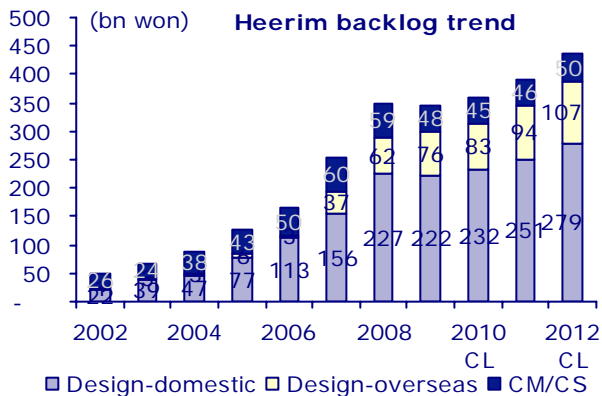
Source: CLSA Asia-Pacific Markets

To gain market share in a weak environment

We expect 2009 domestic order to go down 35% and overseas down 40% considering the weak 1H09 results (-50% YoY) and the sluggish domestic architecture market which orders went down by 45% YoY. We expect slightly better performance than the overall market in 2H09 as Heerim historically outperformed the market during the down turn as in figure 29. This was possible due to their dominant position and market consolidation. We expect full year 09 will be down by 36%YoY but 2H09 to be up 25% HoH from improving market sentiment in both domestic and overseas.

Figure 27

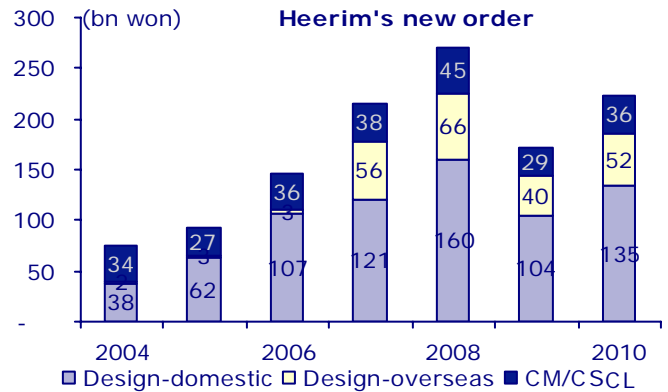
Almost 2 years work accumulated



Source: CLSA Asia-Pacific Markets

Figure 28

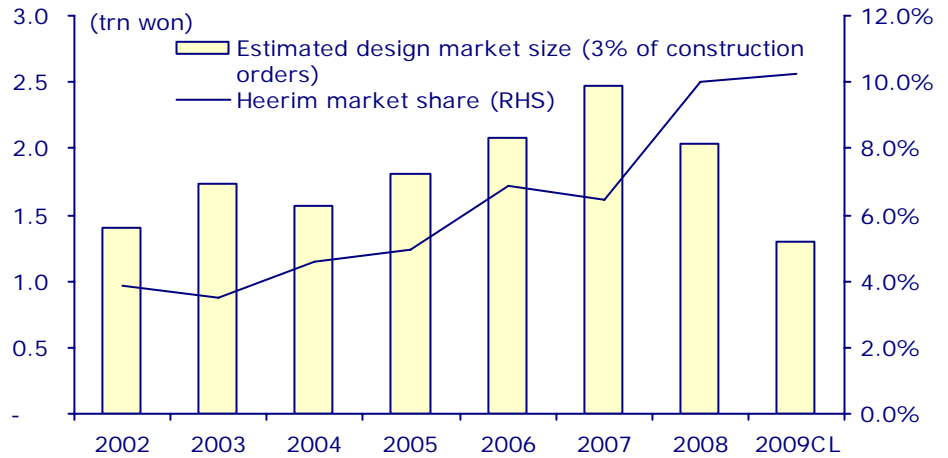
2010 recovers after a plunge in 09



Source: CLSA Asia-Pacific Markets

Figure 29

Heerim gained share while market shrunk



Source: MLTM, CLSA Asia-Pacific Markets

Large scale projects driven-big room to grow

As discussed earlier, due to the government efforts to change the architectural works in Korea and the various nationwide development projects that are planned to come, there are big room for architectural design works to grow. The total project size includes non related areas such as civil works and restoration, etc but doesn't include additional architectural orders to come out related to the projects. It may not be 100% representative of Heerim's potential orders but gives us an idea on the scale keeping in mind that 2-5% of total cost is allocated to design.

Figure 30

Recently nounced development projects in metropolitan area

Location	Completion	Total Project size (trn won)	Comments
Namsan Renaissance	2013	0.2	Tear down old buildings and
South West Renaissance	2020	20.3	Development into industrial, business, R&D and finance core areas
Han River Renaissance	2030	0.9	Heerim is doing advisory works to the Seoul City
North East Renaissance	2018	8.0	Revitalize the water way, develop into a new economy and cultural city
Industrial New Town	2017	3.4	30 new towns to get favourable plot ratio, height limit, etc
Yongsan International Business Zone	2016	28.0	Landmark buildings to be built.
Lotte World no.2	2012	1-2	Heerim did design for approval work of 112fl building.
Living in Riverside Kyunggido	2013	22.9	Works along the Han River outside Seoul.
Private land rezone and development	Depends on company	1-2trnwon per project	Total 694,000 sqm for 16 corp got approval to develop their land in Seoul.
4 Major River Development	2012	22.2	Nationwide river revitalization project
Kyungin Canal	2011	2.2	

Source: CLSA Asia-Pacific Markets

A lot of these projects include plans to build 100 story buildings and such sky scrapers can only be designed by top tier big design firms like Heerim. As we can see in figure 31, demand is much higher in taller buildings and it is likely to see the strongest growth in the future. The tallest building is 63floor right now, but there will be more than 10 buildings that are above 100 floors in 5 to 6 years based on current plans.

Figure 31

Buildings in Korea are getting taller

	1995	2001	2004	2005	2006	2007	2008	YoY	7yr cagr	13yr cagr
1-10	5,665,572	5,881,998	6,299,847	6,308,022	6,215,847	6,384,927	6,449,674	1.0%	1.3%	1.0%
11-20	9,507	35,122	49,410	53,355	54,941	60,461	63,702	5.4%	8.9%	15.8%
20-30	293	3,414	7,525	8,241	8,652	9,904	10,720	8.2%	17.8%	31.9%
over 31	7	20	108	164	215	330	503	52.4%	58.5%	38.9%
Total	5,675,380	5,920,554	6,356,890	6,369,782	6,279,655	6,460,489	6,556,713	1.5%	1.5%	1.1%

Source: MLTM, CLSA Asia-Pacific Markets

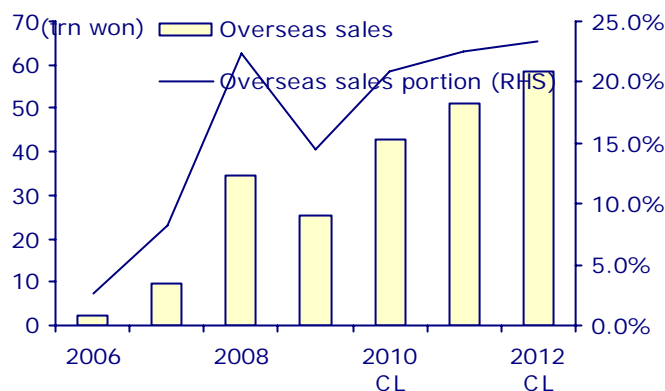
Overseas keeping margins high

With ample backlog from overseas, comprising 22% of total, we expect Heerim to see slight improvement in OP margin from current 10.1% to 10.8% in 2011 as overseas sales gets fully recognized. This is way above industry average as the top 4 can only get high single digit due to the small overseas exposure if any.

Following a decline of new orders and slow sales recognition in 09, we expect Heerim's sales from overseas to be 15% of total sales in 2012, down from 22% in 08. The weaker new orders were due to the globally squeezed financial conditions which slowed down new projects. However, we expect overseas orders to grow by 23% in 2010 as these orders were pushed rather than cancelled. Heerim's management is very active in growing in this area as they saw better margins and perception towards design compared to the domestic market. Also, about 70% of clients in overseas orders are public entities which orders are more from delay rather than cancellation because these emerging countries, where Heerim has exposure to, have ambitious development plans to come through. The company is sensing some pick ups and expecting sizable projects that are over 10bnwon to come in 2H from Thailand, Vietnam, etc. As we have seen Middle East plant orders picking up, boosting Korean players' new orders, architectural works are expected to recover as well in 2H09 and 2010.

Figure 32

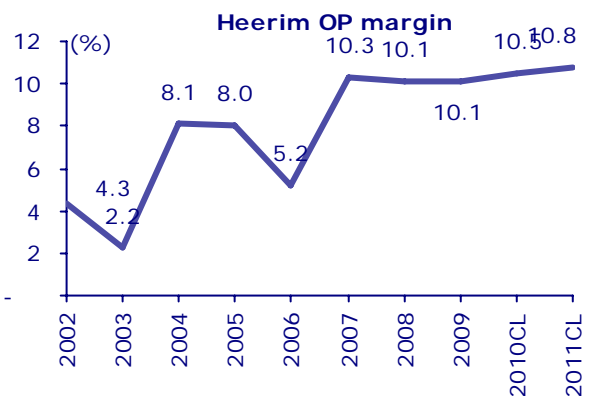
Overseas weak this year from slow progress and orders



Source: CLSA Asia-Pacific Markets

Figure 33

Overseas sales and economy of scale helping margin



Source: CLSA Asia-Pacific Markets

Figure 34

Heerim's major overseas projects – completed and on going

Year of order	Client	Project	Contract size (m won)
2003	Chunhee International Town	Chunhee International Town	507
	Beijing Yaburi Asset Magmt	Yaburi Project	911
	China Suhan Goshin Development	China Suhan Goshin Development	431
2004	EURL Park Group	Golden Village	1,191
	Mandarin Corp	China Sungdo Resort	20
2005	Vietnam Electricity Corp	Vietnam Electricity Corp HQ	2,544
2006	Axon Gulf	Dubai Sports City Office Tower	1,150
2007	Middle East Development	Yemen, The City of Light	2,343
	LANDEVEL Co.	Cambodia PhnomPenh Residential	3,280
	Middle East Development	Al Noor City, Djibouti	1,125
	Middle East Development	Hotel Crescent in Baku, Azerbaijan	14,301
	The State Oil Company of Azerbaijan	SOCAR HQ building	5,737
	GRINDLE RESOURCES LIMITED	Ukraine Residential master plan	649
	GiLAN infaat	Crescent place	8,602
	Keangnam Ent	Hanoi Landmark Tower complex	11,988
	Vietnam National Oil Co	Hotel complex development project	13,309
	Evergreen Signature Inverstmen	Dubai Majan Housing Project	9,861
2008	GB America Inverstment Inc.	LA Residential	4,901
	STX Dailan	China Dailan project	1,699
	Vietnam Ministry of Foreign Affairs	VMOFA HQ building	10,041
	HUB Holding	Saadiyat Marina SM8-15	8,578
	Shakeel Shaikh	City of Arabia 2	5,751
	T.H.T DevelopmentCo.,Ltd	Tay Ho Tay new city phase 1	4,064
	Unique Properties	Dubai Warter front residence	2,707
	GILAN INSAAT	Azerbaijan Crescent City	3,058
	Hanoi Telecom	Hanoi Telecom HQ	7,165
	GiLAN HOLDING	Baku Tower	6,400
2009	HUB HOILDINGS	AbuDhabi MBZ City C75 complex	1,037

Source: FSS, CLSA Asia-Pacific Markets

BUY with +34% upside

We derive our target price of 15,700won based on 14x10CL PE. Without any listed peers to compare, we think 14x is appropriate due to its strong growth of +18% over 3 years from 09 to 12 in EPS, high dividend payout and returns. Our DCF valuation also supports our view, which derives a per share value of 15,600won.

Figure 35

DCF valuation

(bn won)	2009CL	2010CL	2011CL	2012CL	2013CL
Free cash flow	(2.3)	(1.6)	5.1	15.0	17.6
Discount rate (WACC)	9.9%	9.9%	9.9%	9.9%	9.9%
PV of cashflow	(2.3)	(1.4)	4.2	11.3	12.0
PV of terminal value	203				
Enterprise value	226				
Net debt (2009)	2.1				
Equity value	224				
Shares in issue (m)	14.35				
Equity value/share (won)	15,600				

Source: CLSA Asia-Pacific Markets

1) **Strong revenue and EPS growth:** From 96 to 08, cagr was 20.8%. From its 2 years work in backlog, growing industry size, market share gain, and increasing new orders from recovering construction market, we forecast +13% cagr in revenue for 3 years from 09CL to 12CL. EPS will grow by 18% cagr over the same period from improved efficiency and higher revenue/employee.

Figure 36

Implied growth rate under 14x PE multiple

Risk free rate	5%
Beta	0.75
Equity risk premium	7%
Cost of equity	10.3%
ROAE	20%
Pay out Ratio	78%
Target P/E	14.0
Implied growth rate	4.4%

Source: CLSA Asia-Pacific Markets

The 14x10CL EPS seems conservative as it implies a stable growth rate of 4.4% while Heerim's Cagr over the last 10 years was 24% and we expect 13% for the next 3 years.

Figure 37

Two stage model for estimating multiples - PE sensitivity on growth rates

		Stable growth rate				
		1.0%	2.0%	3.0%	4.0%	5.0%
High growth rate (3yr)	4.0%	9.3	10.3	11.6	13.3	15.7
	11.0%	11.1	12.4	14.0	16.1	19.0
	15.0%	12.3	13.7	15.5	17.8	21.1
	18.0%	13.3	14.8	16.7	19.2	22.7
	20.0%	13.9	15.5	17.5	20.2	23.9

PE formula = $[PO \cdot (1+g) \cdot [1 - ((1+g)^n / (1+COE)^n)] / (COE-g)] + [PO_n \cdot (1+g)^n \cdot (1+gn) / (COE - gn)(1+COE)^n]$, assumption same as fig 36.

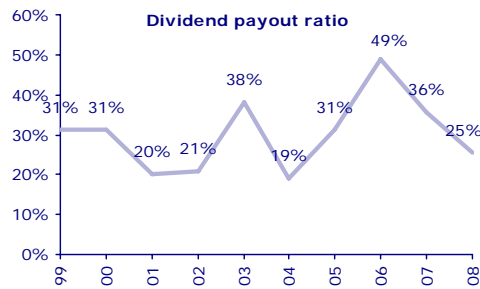
When we look at the 2 stage multiple model, our target price equates to 11.6x2011CL PE, which implies a 4% growth rate for 3 years while we are forecasting 18%. The 18% high growth rate for 3 years and a steady growth rate of 3% would derive a multiple of 16.7x on 2011, which equates to 19.1x10CL.

While don't think the DCF valuation is fully appropriate for a growing business like Heerim's, our multiple seems conservative based on above calculation. However, one discount factor would be the liquidity constraint being a small cap company. Also, as the nature of this business is highly dependent on execution and new orders, it has a rather low order visibility, especially when we are expecting a turnaround in 2H from a weak 1H. If we get increased conviction on new order flow and faster progress, there would be potential to apply a higher multiple.

- 2) **High dividend payout:** Historic payout ratio has been well above 20%, paying 49% in 06, 35.5% in 07, 25.5% in 08. We expect same level of payout ratio as 08 for 09 as the management guides a continuous shareholder friendly policy.

Figure 38

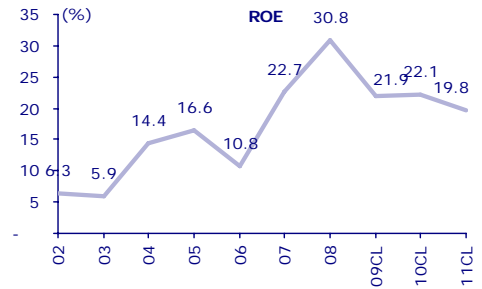
High payout



Source: CLSA Asia-Pacific Markets

Figure 39

High returns



Source: CLSA Asia-Pacific Markets

3) **High returns:** ROE was 22.7% in 07, 30.8% in 08 and we expect 21.9% this year. Decline of earnings this year is due to the exceptional fx gain in 08 of 4.2bn won. The nature of its business requires low capital which is mainly used for computers, software and additional office space as they own 1 building for their office. The value spread between ROIC and WACC will decline from 11.8 to 9.2 in 09 from increasing accounts receivables and advance receipts but we expect such conditions to improve from 2010, widening the value spread to 10.7.

Figure 40

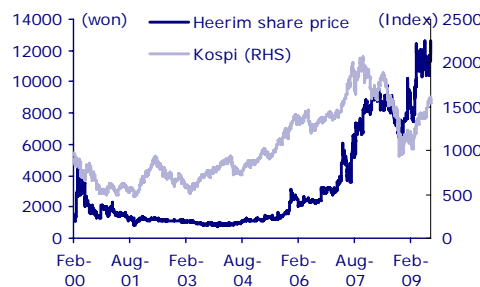
Value spread

	2006	2007	2008	2009CL	2010 CL	2011CL
Total asset	37.8	57.2	74.5	103.5	117.5	132.9
-Cash	3.3	6.3	2.5	11.7	6.0	6.4
-ST investment	1.1	1.0	1.2	1.2	1.2	1.2
-LT investment	4.0	4.2	2.9	2.9	10.4	17.9
-Non interest bearing current liabilities	3.7	9.3	15.8	18.1	20.1	21.8
Invested capital (bn won)	25.7	36.5	52.1	69.6	79.8	85.6
NOPAT (bn won)	4.0	8.5	11.2	13.1	16.2	18.3
ROIC (%)	15.7	23.4	21.4	18.9	20.4	21.4
WACC (%)	9.7	9.7	9.7	9.7	9.7	9.7
Value spread (ROIC-WACC)	6.0	13.7	11.8	9.2	10.7	11.7

Source: CLSA Asia-Pacific Markets

Figure 41

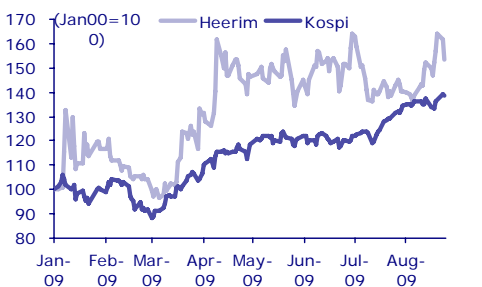
Heerim vs Kospi since listing in 2000



Source: Wisenet, CLSA Asia-Pacific Markets

Figure 42

YTD Heerim vs Kospi



Source: Wisenet, CLSA Asia-Pacific Markets

Scenario analysis

Our base case assumes a slightly recovering 2H vs 1H based on improved construction industry sentiment, order pipeline and Heerim market share gain from current 10% to 11% as they usually outperform in the downturns. For 2010 and 2011, new order growth is based on their order pipeline delayed from previous years and upcoming mega development projects.

Bear case -7.4% vs Bull case +30% 10CL EPS

Our forecast seems realistic given the macro environment and order pipeline

Bear case assumes continuous weak orders throughout this year and a weaker recovery next year with sluggish sales recognition by adjusting growth and progress ratio by 1-3%p, which gives a 7.4% lower EPS for 2010 compared to our base case. On the other hand, our bull case sees a stronger recovery in 2H, achieving same orders as 08 for 09 and a stable progress rate, giving 30% upside to our 2010 EPS.

However, we consider our base case is the most realistic case where we assume better new orders in 2H vs 1H by 25% based on their delayed project pipeline and a better performance than the industry by increasing their estimated market share from 10% to 10.5%. 2010 new orders will be up 29% YoY from projects delayed from 09. 2010 and 2011 sales will be driven by orders received in 08 and 09, and we assume faster sales recognition and recovery in new orders up to 08 level by 2011, assuming a pickup in the overall construction industry.

Figure 43

Scenario analysis				
Base case (13.2% sales Cagr)	2008A	2009CL	2010 CL	2011 CL
New order growth (%)	26%	-36%	29%	17%
Domestic design	32%	-35%	30%	15%
Overseas design	18%	-40%	30%	23%
CM	28%	-36%	30%	17%
Sales	155.8	174.8	206.3	226.2
Domestic design	83.6	109.2	124.8	135.4
Overseas design	34.8	25.3	43.0	51.1
CM	37.4	40.3	38.5	39.7
Net profit (bn won)	15.8	13.5	16.1	18.4
EPS (won)	1,101	938	1,120	1,282
Bear case (9.3% sales Cagr)				
New order growth (%)	26%	-41%	27%	16%
Domestic design	32%	-40%	28%	14%
Overseas design	18%	-45%	28%	22%
CM	17%	-41%	23%	12%
Sales	155.8	157.9	191.1	203.6
Domestic design	83.6	96.8	115.0	123.2
Overseas design	34.8	22.6	40.3	44.4
CM	37.4	38.5	35.8	36.1
Net profit (bn won)	15.8	12.3	14.9	16.6
EPS (won)	1,101	859	1,037	1,155
<i>vs Base case</i>	<i>0.0%</i>	<i>-8.4%</i>	<i>-7.4%</i>	<i>-9.9%</i>
Bull case (25.0% sales Cagr)				
New order growth (%)	26%	0%	16%	17%
Domestic design	32%	0%	15%	17%
Overseas design	18%	0%	18%	20%
CM	17%	0%	15%	15%
Sales	155.8	213.4	267.3	304.0
Domestic design	83.6	127.6	159.3	179.3
Overseas design	34.8	38.4	58.6	70.9
CM	37.4	47.4	49.3	53.8
Net profit (bn won)	15.8	16.5	20.9	24.7
EPS (won)	1,101	1,153	1,454	1,722
<i>vs Base case</i>	<i>0.0%</i>	<i>22.9%</i>	<i>29.8%</i>	<i>34.2%</i>

Source: CLSA Asia-Pacific Markets

Issues and risks

9% dilution from CB reflected in our valuation

Convertible bond and potential overseas acquisition

Heerim is very determined to increase their overseas exposure and gain recognition in the global market. That is why they were close to a deal to acquire a US architectural design company last year, which got cancelled due to the global credit crisis.

A smart M&A could be upside to our topline growth and we are more positive towards this acquisition as they have a clear goal-to acquire a US company, maybe not too big but with competitive know-how and expertise so that Heerim could benchmark or learn to increase global exposure. Also, there are many architects including the CEO who has many years of architectural designing experience or education in US or UK which will make the human transition, cultural change, or merger smoother. The company is currently reviewing many options and the final decision is expected to be announced sometime end of this year or early next year.

A convertible bond was issued in July for this purpose, raising total 15bnwon to KDB. This is 9% dilution to existing shares, which is reflected in our valuation but seems not to be in consensus numbers.

3 projects are on hold, we take it out of our forecast

Overseas contract cancellation risk

CLSA noticed that 3 overseas projects in the company's backlog are on hold. 3.3bnwon Phnom Penh residential project progressed only 5% for more than 2 years and 2 more housing projects in Dubai and LA are also on hold with less than 10% progress due to the weak property market. So we took 18bnwon out from our backlog forecast due to the risk of cancellation. We would include it back if the project resumes as Heerim is a play on global construction at the end of the day.

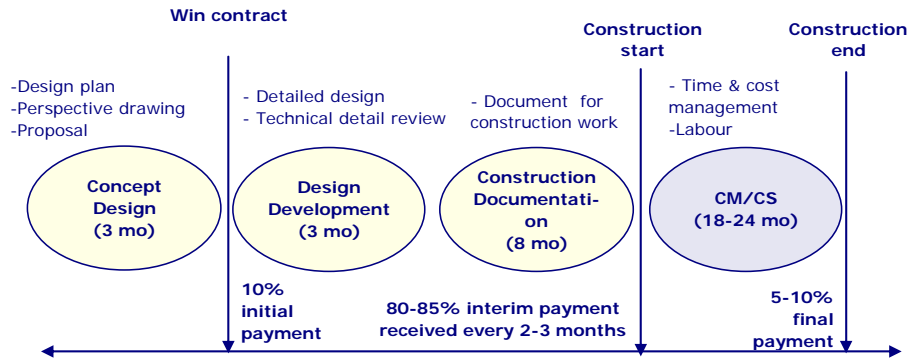
Heerim cannot be free from the weak construction industry

Impacted by weak domestic construction industry

As in figure 44, a typical design contract payment would start with an initial payment of 10% when getting the order. The next stage, design development, will start right after receiving the order. Interim payments are received every 2-3 months and 90-95% of total fee will be received before construction starts. Remaining 5-10% will be received when construction completes. Payments for CM/CS orders will be received every 1-2 months over the period of construction. Getting most payment before construction starts and having less than 20% of sales in residential space, Heerim is less exposed to a developers' default risk from low presale during construction, or debt take over like construction companies as they don't guarantee for construction projects.

Figure 44

Typical design order payment schedule

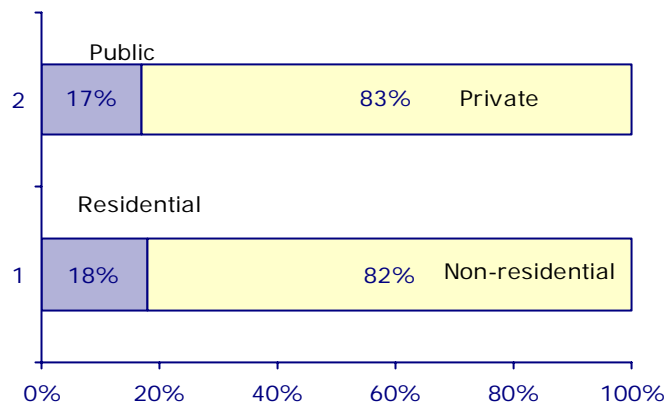


Source: Heerim, CLSA Asia-Pacific Markets

However, they have been impacted from the weak construction market, both in domestic and overseas as we can see the receivable days have been trending up. Squeezed liquidity of construction companies and scaled back private investment are the main reason but the major construction companies' financial condition has been improving compared to the bottom, so we are assuming similar receivable days in the future. Govt increased public spending into the civil engineering work this year as part of the stimulus but Heerim didn't benefit as only 17% comes from public.

Figure 45

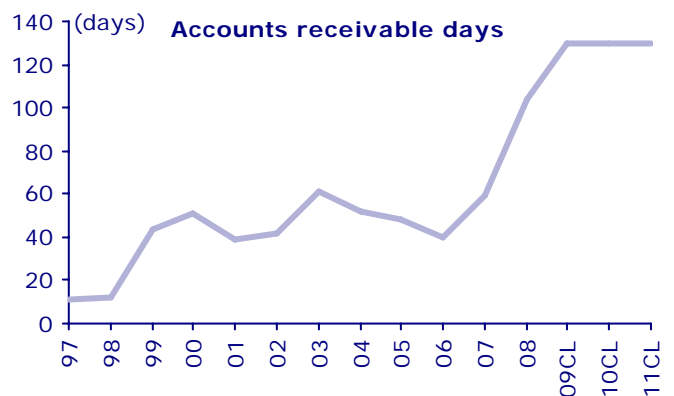
Less exposed to the housing market



Source: Heerim, CLSA Asia-Pacific Markets

Figure 46

But still impacted by the weak construction industry



Source: CLSA Asia-Pacific Markets

09 orders and sales guidance was too bullish

Likely to miss 09 guidance

Company's guidance for 09 is very bullish but official guidance hasn't been lowered yet. The 1H new orders were down by 50% YoY and sales growth was only 5%, achieving only 24% and 38% of guidance respectively. Even considering stronger seasonality in 2H09, we believe the guidance of 200bnwon sales or 28% growth and 20% order growth are too bullish. Our forecast of new order decline of 36% and sales growth of 12.2% seems more realistic. We see any disappointment in the likelihood of lower guidance as a buying opportunity.

Summary P&L forecast (wonbn)

Year to 31 December	2007A	2008A	2009CL	2010CL	2011CL
Revenue	120	156	175	206	226
Operating Ebitda	14	18	20	25	28
Operating Ebit	12	16	18	22	24
Interest income	0	0	0	0	0
Interest expense	0	0	0	0	0
Other items	0	4	0	0	0
Profit before tax	13	20	18	21	25
Taxation	(4)	(5)	(5)	(5)	(6)
Minorities and other	0	0	0	0	0
Profit	9	16	14	16	18

Summary cashflow forecast (wonbn)

Operating Ebit	12	16	18	22	24
Depreciation/amort	2	2	2	3	4
Working capital - trade	16	30	46	55	60
Other operating items	(13)	(54)	(59)	(57)	(59)
Operating cashflow	17	(6)	6	23	30
Net interest/taxes/other	(10)	2	(5)	(13)	(13)
Cashflow	7	(4)	2	10	17
Capital expenditure	(2)	(3)	(4)	(4)	(5)
Acq/inv/disposals	(6)	6	0	(7)	(7)
Free Cashflow	(1)	(1)	(2)	(2)	5
Ord div paid/Other items	4	(2)	(3)	(4)	10
Decrease in net debt	3	(4)	(6)	(6)	15

Summary balance sheet forecast (wonbn)

Cash & equivalents	6	2	12	6	6
Debtors - trade	20	44	62	73	80
Inventories - trade	0	0	0	0	0
Other current assets	9	3	3	3	3
Fixed assets	9	10	12	13	14
Intangible assets	5	5	4	4	4
Other term assets	8	10	10	18	25
Total assets	57	75	104	117	133
Short-term debt	0	0	0	0	0
Creditors - trade	0	0	0	0	0
Other current liabs	5	10	11	12	13
Long-term debt/CBs	0	0	15	15	0
Other long-term liabs	6	9	10	12	12
Minorities/other equity	0	0	0	0	0
Shareholder funds	46	56	67	79	107
Total liabs & equity	57	75	104	117	133

Ratio analysis

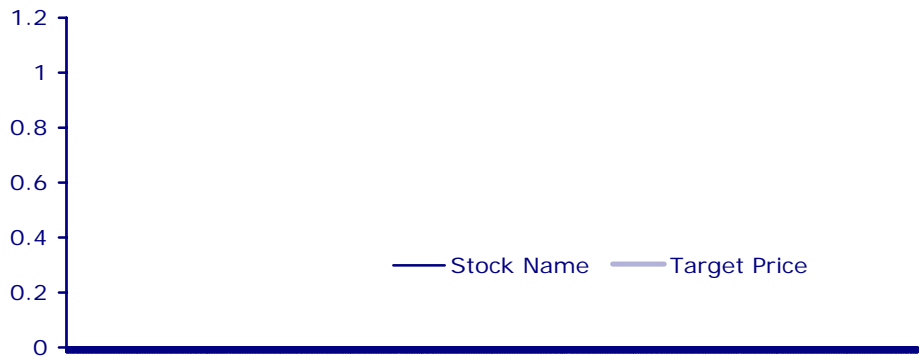
Revenue growth (%)	31.3	29.7	12.2	18.0	9.7
Op Ebitda growth (%)	133.8	27.0	10.5	24.1	14.1
Op Ebit growth (%)	162.0	26.9	12.2	22.2	13.0
Op Ebitda margin (%)	11.9	11.7	11.5	12.1	12.6
Op Ebit margin (%)	10.3	10.1	10.1	10.5	10.8
Net profit margin (%)	7.5	10.1	7.8	7.8	8.1
Dividend payout (%)	79.0	28.3	27.3	27.3	24.9
Tax rate (%)	30.2	22.5	25.0	25.0	25.0
Ebitda/net int exp (x)	(73.3)	(45.9)	(302.6)	139.2	(236.2)
Net debt/equity (%)	(22.6)	(9.5)	0.6	(1.8)	(22.6)
Gross debt/equity (%)	0.0	0.0	22.5	19.0	0.0
Net debt/op Ebitda (x)	(0.7)	(0.3)	0.0	(0.1)	(0.9)
Gross debt/op Ebitda (x)	0.0	0.0	0.7	0.6	0.0
Return on equity (%)	22.7	30.8	22.1	22.1	19.8
ROCE (%)	41.3	46.1	30.6	29.9	30.4
Return on assets (%)	18.9	23.9	15.3	14.5	14.7

Source: CLSA Asia-Pacific Markets

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Figure 3

Type chart title here XXXXXXXXXXXXXXXXX



Source: CLSA Asia-Pacific Markets

Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; O-PF = Expected to outperform the local market by 0-10%; U-PF = Expected to underperform the local market by 0-10%; SELL = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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Note: In the interests of timeliness, this document has not been edited.

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