

BUY (maintain)

Hyundai Heavy Industries (009540)

History Being Rewritten!

Sanghwa Lee Analyst
Shipbuilding, Machinery
82-2-2003-2909 sanghwa.lee@hdsrc.com

Daesung Kim RA
82-2-2003-2933 daesung.kim@hdsrc.com

Current price (Apr 1)	KRW520,000
Fair value	KRW620,000
Reuters code	009540.KS
Bloomberg code	009540 KS
Industry/Sector	Shipbuilding
Rating	Overweight
Market cap	USD36.2bn
Ordinary shares issued	76,000,000shrs
Free float	57.6%
KOSPI	2,121.01
KOSDAQ	532.06
Avg T/O Vol (60d)	269,194shrs
Avg T/O Val (60d)	USD114.8mn
Foreign ownership	19.6%
3yr CAGR of adj. EPS (10-12)	14.0%
Market's 3yr CAGR of adj. EPS	46.8%
52wk high/low	KRW520,000 KRW199,500
Beta (12M, daily return)	0.7
Major shareholders	Mong-Jun Jung 21.3%

Share price about to reach all-time high; Evolving into new company

With Hyundai Heavy Industries' share price nearing its historical high, questions have been raised as to whether the company will be able to replace its share price record soon. We have confidence in Hyundai Heavy's long-term growth potential and maintain our view that the company will break its share price record. The reason for this view is the fact that Hyundai Heavy has evolved into a new company compared to 2007.

Share price forecasts cannot be made based solely on dips in shipbuilding orders from 2007

Hyundai Heavy's shipbuilding orders are expected to slide from USD15.7bn in 2007 to USD5.7bn on average in 2010-11, which clouds the company's share price outlook. However, shipbuilding orders alone cannot predict the company's share price, because: 1) its total orders are expected to increase from USD25bn in 2007 to USD25.6bn in 2011; 2) the proportion of non-shipbuilding orders in total new orders is expected to expand from 37% in 2007 to 71% in 2011; and 3) the proportion of non-shipbuilding OP is expected to reach 69% of the company's 2011 OP.

Rising orders across the board, qualitative growth in OP, and new cracking units at Hyundai Oilbank

Hyundai Heavy has advanced, in qualitative terms, compared to 2007. First, annual new orders have neared an all-time high. And its various businesses have expanded across the board. Accordingly, the quality of the company's OP has been upgraded by a notch. Moreover, new cracking units at Hyundai Oilbank will begin full-fledged operations in May, and earnings from the new units are expected to beat estimates and therefore provide an additional boost to enterprise value going forward.

1Q11 results to be in line with expectations; Earnings contraction to be limited in 2H11

1Q11 OR and OP will likely come in at KRW6.2tr and KRW925.1bn, respectively, in line with market consensus. Both top and bottom lines appear to have leveled up in 1Q11, as they did in 4Q10. Even if declines in newbuilding prices take effect in 2H11, a YoY earnings contraction is unlikely to be steep.

Fair value of KRW620,000 retained, but further upside remains!

We maintain a fair value of KRW620,000 derived based on PBR and ROE. The fair value may be revised up, if earnings at Hyundai Oilbank improve in earnest. We also maintain a BUY rating, in light of the heightened likelihood of share prices breaking a historical high, long-term growth prospects, and qualitative upgrades in earnings.

Price performance	1M	3M	6M
Absolute	19.5%	17.4%	66.4%
Relative	9.3%	13.5%	47.2%



FY-end	12/08A	12/09A	12/10A	12/11F	12/12F
OR (KRWbn)	19,957.1	21,142.2	22,405.2	26,188.7	28,609.5
OP (KRWbn)	2,206.2	2,222.6	3,434.4	3,428.0	3,394.2
EBT (KRWbn)	2,949.6	2,648.1	4,784.3	4,401.8	4,407.5
NP (KRWbn)	2,256.7	2,146.5	3,761.1	3,433.4	3,437.8
EPS (KRW)	30,531	28,243	49,489	45,176	45,235
Adj. EPS (KRW)	32,001	30,367	50,600	44,964	44,942
PER* (x)	13.7 - 3.6	8.2 - 4.9	9.0 - 3.4	11.6	11.6
PBR (x)	2.9	1.3	2.3	2.2	1.9
EV/EBITDA (x)	4.9	5.0	9.3	10.5	10.3
ROE (%)	40.7	27.9	31.8	22.3	18.5

Source: Company data, Hyundai Securities

Evolving into Different Company Compared to 2007

Possibility of breaking share price record

Hyundai Heavy’s share price has recently neared its all-time high of KRW550,000 set in Nov 2007. Will the company break the record?

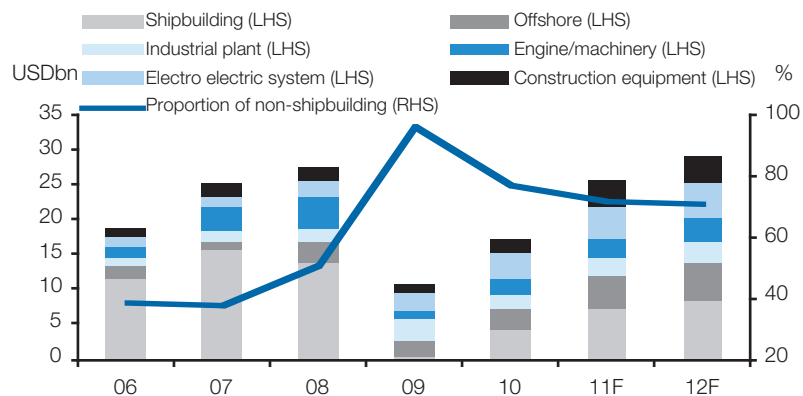
Shipbuilding orders alone no longer sufficient in reflecting Hyundai Heavy’s performance

Hyundai Heavy’s shipbuilding orders are expected to slide 54% from USD15.7bn in 2007 to USD4.1bn in 2010 and USD7.3bn in 2011. Given the shipbuilding order outlook, it appears unlikely that the company will replace its share price record soon.

However, we believe Hyundai Heavy has evolved into an entirely new company compared to 2007. And we expect the company to set new share price and earnings paths based on the following.

- 1) Its total orders are expected to increase from USD25bn in 2007 to USD25.6bn in 2011 and USD29.1bn in 2012.
- 2) The proportion of non-shipbuilding orders in total new orders is expected to expand from 37.1% (USD9.3bn) in 2007 to 71.4% (USD18.3bn) in 2011 and 70.8% (USD20.6bn) in 2012, which suggests that Hyundai Heavy has evolved into a total heavy industries company.
- 3) The proportion of non-shipbuilding OP is expected to reach 69% (common SG&A expenses excluded) of the company’s 2011 OP.

Fig 1: Non-shipbuilding segments driving up total orders



Source: Company data, Hyundai Securities

Operating environment different from 2007

When Hyundai Heavy’s share price peaked in 2007, the market expected that the company’s share price would ride an upcycle, aided by the robust shipbuilding industry. In other words, such rosy forecasts of the shipbuilding/shipping industries led the uptrend of Hyundai Heavy, the No. 1 global shipbuilder. However, the shipbuilding/shipping industries have completely deviated from expected trajectories since the fall of Lehman Brothers and the financial crisis. The Baltic Dry Index (BDI) nosedived from 11,793 in 2008 to a trough of 663 and then rallied to 1,530 as of end-Mar 2011.

Evolving into total heavy industries company

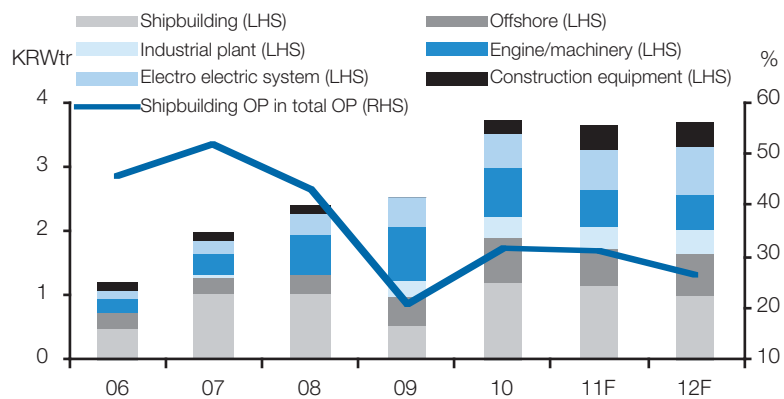
Given the evolution into a total heavy industries company, it would be difficult to predict the future direction of Hyundai Heavy’s share price solely based on the soured shipbuilding/shipping market conditions and consequent order dips. Although the proportion of new shipbuilding orders to total new orders declined from 63% in 2007 to 24% in 2010 and to an estimated 29% in 2011, the value of new shipbuilding orders has been on an uptrend from KRW21.1tr in 2009 to KRW22.4tr in 2010 and to an estimated KRW26.2tr in 2011.

Non-shipbuilding segment and Hyundai Oilbank to fuel growth

Amid oil price hikes and the depletion of natural resources, the offshore segment will likely grow fast, and divisions involving plants, engines, construction machinery (excavators), and electro electric system (power transmission/distribution facilities) are in a growth mode. Hyundai Heavy has evolved into a comprehensive heavy industry player, with its business portfolio spanning across new renewable energy sources such as solar and wind power. With the takeover of Hyundai Oilbank, Hyundai Heavy is now no longer represented by shipbuilding businesses alone.

We believe Hyundai Heavy deserves a higher enterprise value than in 2007 due to the size and quality of its OP. All-time high shipbuilding orders reached in 2006-2008 have been translated into OP in the shipbuilding division in 2009-2011. Hence, in order to compare the quality of profitability, it would be effective to compare OP in 2010, when shipbuilding earnings hit a record high, and OP during 2011-2012, when the proportion of shipbuilding division will likely diminish.

Fig 2: OP to be leveled up driven by non-shipbuilding divisions



Source: Company data, Hyundai Securities

Qualitative improvement in profitability

The company’s OP was KRW3.44tr in 2010 and is projected at KRW3.43tr in 2011 and KRW3.39tr in 2012, and the proportion attributable to shipbuilding is estimated at 31.7%, 31.3%, and 26.5%, respectively. While shipbuilding OP keeps decreasing in 2011 and 2012 compared to 2007, the overall size of OP is being maintained. This indicates that shipbuilding’s impact on profitability is diminishing, while the quality of OP is improving.

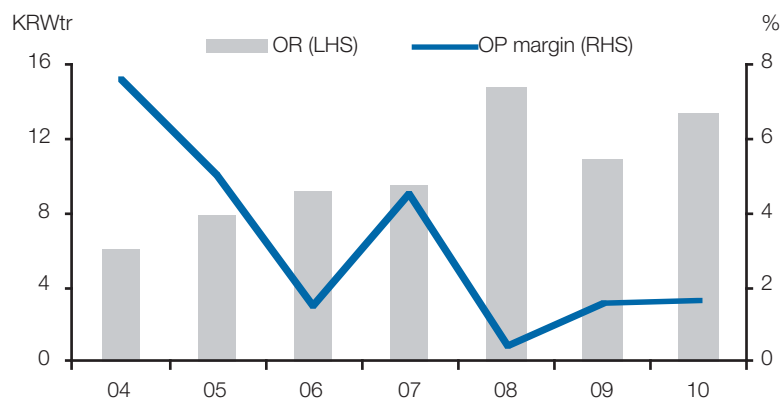
Hyundai Oilbank finished with cracking capacity expansion

Hyundai Oilbank needs to be reflected in the valuation of Hyundai Heavy Industries. Hyundai Heavy Industries currently owns 91% of Hyundai Oilbank (after winning a lawsuit against IPIC in Aug 2010, which earned it an additional 70% stake), and the book value reaches KRW3.1tr. Hyundai Oilbank has recently expanded its cracking capacity, and the new lines, currently in a trial mode, will begin full-fledged operations in May.

Hyundai Oilbank earnings to beat expectations; Enterprise value to exceed book value

Hyundai Oilbank recorded OR of KRW13.3tr and OP margin of 1.7% in 2010. Hyundai Heavy Industries’s projection for 2011 OR at Hyundai Oilbank was KRW16.4tr early in the year. However, Hyundai Oilbank is expected to beat the estimate amid the booming oil refining industry in Korea. Its profitability is also expected to improve from 2010. Also, the full launch of its cracking facilities has the potential to accelerate earnings improvement further. Accordingly, Hyundai Oilbank’s enterprise value is expected to exceed the book value of KRW3.1tr.

Fig 3: Hyundai Oilbank earnings trend



Source: Company data, Hyundai Securities

Upgraded quarterly results to be maintained

1Q11 OR and OP are projected at KRW6.2tr and KRW925.1bn, respectively, in line with market consensus. Although the OR and OP results will be a slight retreat QoQ, they will still represent growth of 17% and 5% on a YoY comparison. Thus, upgraded quarterly results will be maintained as in 4Q10.

Fig 4: 1Q11 earnings to be sound

(KRWbn)	1Q11F	%YoY	%QoQ	1Q10	4Q10	Consensus	%Diff.
OR	6,208.7	17.0	(3.4)	5,306.4	6,429.9	6,362.6	(2.4)
OP	925.1	5.0	(6.0)	880.9	983.9	934.2	(1.0)
EBT	1,191.6	0.2	(11.6)	1,189.4	1,347.5	1,268.1	(6.0)
NP	929.4	0.3	(12.4)	926.2	1,061.0	971.6	(4.3)
OP margin (%)	14.9			16.6	15.3	14.7	
EBT margin (%)	19.2			22.4	21.0	19.9	
NP margin (%)	15.0			17.5	16.5	15.3	

Source: Hyundai Securities

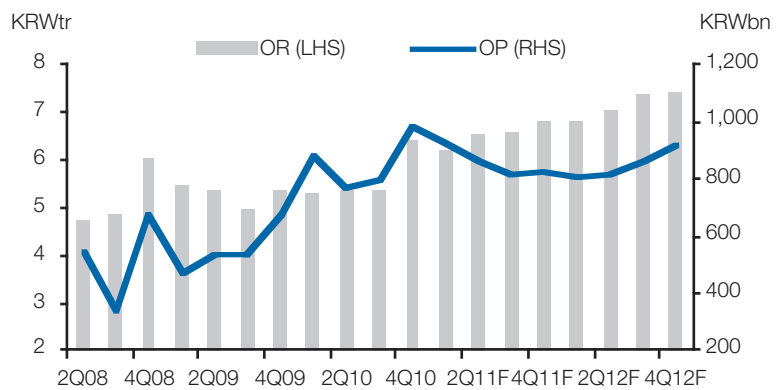
Earnings unlikely to contract much

Shipbuilders' earnings are expected to begin a YoY downtrend from 2H11, as orders received since 2009, when the shipbuilding price began a downcycle, are recognized into sales. However, Hyundai Heavy Industries is unlikely to see its overall OP contract much thanks to the growth in its non-shipbuilding business.

Adoption of IFRS to offer opportunity for subsidiaries to be revaluated

Following the adoption of IFRS, Hyundai Heavy Industries will announce consolidated financial statements that reflect earnings results of Hyundai Samho Heavy Industries and Hyundai Oilbank. The adoption of IFRS and release of consolidated financial statements do not change the company's fundamental enterprise value. However, when the financial statements of subsidiaries become apparent, unlike in the past, when financial statements reflected only headquarter OP and equity method income, the market may be able to re-evaluate the value of Hyundai Heavy Industries and its subsidiaries.

Fig 5: Size of OP to be upgraded



Source: Company data, Hyundai Securities

Share price performance to follow path different from existing shipbuilding stock cycles

Shipbuilding share prices have been range bound recently due to a mixed bag of concerns over possible heavy plate price markups and anticipations for LNG-related orders. However, Hyundai Heavy Industries is increasingly likely to walk a different path from existing shipbuilding stock cycles amid the growth of the company's non-shipbuilding business. We believe the company has evolved into a different company from the one we saw in 2007, and it is bound to follow a new path in terms of share price and earnings.

More upsides ahead

We maintain BUY and a fair value of KRW620,000 for Hyundai Heavy Industries. Our fair value is based on a fair PBR that factors in ROE and market PER. However, the fair value may be revised up later, as subsidiary values are anticipated to rise, including expected earnings improvement at Hyundai Oilbank. Share prices are also set to rally beyond the fair value.

Profit & Loss					
(KRWbn)	12/08A	12/09A	12/10A	12/11F	12/12F
Operating revenue	19,957.1	21,142.2	22,405.2	26,188.7	28,609.5
Export ratio (%)	90.0	90.0	40.8	89.3	89.1
Cost of goods sold	(16,812.0)	(17,997.4)	(17,734.8)	(21,116.2)	(23,413.6)
Gross profit	3,145.1	3,144.8	4,670.3	5,072.5	5,195.8
SG&A expenses	(938.9)	(922.2)	(1,236.0)	(1,644.6)	(1,801.7)
Operating profit	2,206.2	2,222.6	3,434.4	3,428.0	3,394.2
EBITDA	2,597.0	2,668.2	3,926.6	3,912.1	3,861.6
Non-operating accounts	743.5	425.5	1,350.0	973.8	1,013.3
Net interest income	273.4	133.1	82.1	1.4	52.8
Net F/X gains	55.5	141.8	(16.8)	12.3	19.3
Equity method gains	619.9	285.0	1,247.0	937.2	878.8
Net disposal gains	14.8	58.4	18.8	0.0	0.0
Earnings before taxes	2,949.6	2,648.1	4,784.3	4,401.8	4,407.5
Income taxes	(693.0)	(501.6)	(1,023.2)	(968.4)	(969.6)
Net profit	2,256.7	2,146.5	3,761.1	3,433.4	3,437.8
Net exceptionals	(149.9)	(212.9)	(108.3)	20.7	28.5
Adj. net profit	2,365.3	2,307.9	3,845.6	3,417.2	3,415.6

Cash Flow					
(KRWbn)	12/08A	12/09A	12/10A	12/11F	12/12F
Cash flow from operating activities	2,382.7	(958.0)	487.8	2,610.1	2,524.6
Net profit	2,256.7	2,146.5	3,761.1	3,433.4	3,437.8
Depreciation & amortization	390.8	445.7	492.2	484.1	467.4
Non-cash expense (ex-deprtn & amtn)	3,676.3	3,959.4	272.4	569.6	518.1
Non-cash income	(2,706.0)	(1,901.9)	(1,307.1)	(1,088.8)	(978.9)
Investment in working capital	(1,235.0)	(5,607.7)	(2,730.9)	(788.2)	(919.8)
Cash flow from investing activities	(1,183.7)	336.8	(2,918.7)	(1,033.4)	(950.0)
Capital expenditure	(1,708.0)	(1,050.7)	(364.9)	(998.7)	(908.7)
Investment in intangibles	(69.7)	(72.1)	(69.7)	(9.5)	(11.2)
Changes in investment assets	(279.1)	(249.5)	(2,551.3)	(1.5)	1.4
Others	873.1	1,709.1	67.3	(23.7)	(31.5)
Cash flow from financing activities	(1,485.3)	586.3	2,422.8	(409.0)	(561.0)
Changes in interest bearing debt	(186.0)	886.0	2,557.7	(143.0)	(295.0)
Equity raised/repurchased	(832.7)	0.0	63.5	0.0	0.0
Dividends paid	(466.6)	(299.7)	(212.2)	(266.0)	(266.0)
Others	0.0	0.0	13.7	0.0	0.0
Increase/decrease in cash	(286.3)	(34.9)	(8.1)	1,167.7	1,013.6
Beginning cash and cash equivalents	953.8	667.5	632.6	624.5	1,792.2
Ending cash and cash equivalents	667.5	632.6	624.5	1,792.2	2,805.8
Gross operating cash flow	1,842.5	3,056.4	3,451.6	3,157.9	3,114.8
Free cash flow	873.8	(3,338.2)	327.1	1,878.9	1,699.6
Net cash flow	(949.3)	(2,621.0)	(2,667.9)	1,340.7	1,346.6
Net cash (net debt)	2,473.0	(147.9)	(2,815.8)	(1,475.1)	(128.5)

Shareholder Value & Financial Structure					
(%)	12/08A	12/09A	12/10A	12/11F	12/12F
ROE	40.7	27.9	31.8	22.3	18.5
ROA	10.7	8.6	14.0	11.0	9.9
ROIC	NA	86.2	40.2	29.5	26.6
WACC	14.5	12.0	13.9	13.1	13.4
ROIC/WACC (x)	NA	7.2	2.9	2.3	2.0
Economic profit (KRWbn)	1,530.8	2,607.8	2,118.2	1,540.7	1,380.4
Total liabilities/equity	351.8	153.6	109.0	95.8	80.5
Net debt/equity	Net cash	1.5	20.4	8.7	0.6
Interest coverage (x)	401.3	78.2	48.8	20.1	21.9

Note: Adj. EPS = [(Adjusted NP - preferred share dividends) + (after-tax dilution adjustment)] / (diluted avg. number of total ordinary shares outstanding)
 Adjusted NP = (Parent NP) - [discontinued operation gains + (net exceptional gains) × (1 - marginal tax rate)]
 Net exceptional gains: Pre-tax exceptional gains (exceptional gains attributable to parent including FX gains, derivatives gains, valuation gains, and one-off gains)
 Source: Company data, Hyundai Securities

Balance Sheet					
(KRWbn)	12/08A	12/09A	12/10A	12/11F	12/12F
Cash and cash equivalents	667.5	632.6	624.5	1,792.2	2,805.8
Short-term investments	1,808.9	109.0	7.0	37.0	75.0
Accounts receivable	4,498.9	4,973.5	5,950.8	5,987.8	6,325.4
Inventories	2,263.3	1,928.6	2,084.2	2,698.7	2,968.7
Other current assets	3,379.1	2,966.2	2,208.7	3,277.5	3,407.3
Current assets	12,617.6	10,609.9	10,875.2	13,793.2	15,582.2
Investment assets	3,224.4	4,866.4	9,089.3	10,028.0	10,905.4
Tangible assets	6,190.0	8,145.5	8,000.2	8,566.9	9,060.3
Intangible assets	262.3	288.5	306.0	263.4	222.5
Other non-current assets	2,986.2	962.3	617.4	612.2	607.1
Non-current assets	12,662.8	14,262.7	18,013.0	19,470.6	20,795.4
Total assets	25,280.4	24,872.6	28,888.1	33,263.7	36,377.6
Accounts payable	2,337.3	1,427.6	1,927.6	1,890.2	1,905.4
Short-term borrowings	0.0	585.3	3,115.0	2,965.0	2,665.0
CP of long-term debt	0.0	0.0	0.0	0.0	0.0
Other current liabilities	14,136.6	10,896.2	8,334.6	9,815.2	10,035.6
Current liabilities	16,473.9	12,909.1	13,377.2	14,670.4	14,606.0
Bonds	0.0	299.1	299.5	302.5	304.5
Long-term debt	3.3	5.2	32.8	36.8	39.8
Financial lease liability	0.0	0.0	0.0	0.0	0.0
Provisions	66.4	63.5	82.2	82.2	82.2
Other non-current liabilities	3,141.6	1,787.3	1,277.5	1,185.5	1,186.9
Non-current liabilities	3,211.3	2,155.1	1,691.9	1,607.0	1,613.4
Total liabilities	19,685.2	15,064.2	15,069.1	16,277.3	16,219.3
Paid-in capital	380.0	380.0	380.0	380.0	380.0
Capital surplus	2,818.6	2,869.6	2,954.4	2,954.4	2,954.4
Capital adjustment	(1,762.0)	(1,697.8)	(1,705.5)	(1,705.5)	(1,705.5)
Accumulated other comprehensive income	(498.5)	1,752.7	2,137.1	2,137.1	2,137.1
Retained earnings	4,657.1	6,503.9	10,052.9	13,220.3	16,392.1
Total equity	5,595.2	9,808.4	13,819.0	16,986.4	20,158.2
Total liabilities and equity	25,280.4	24,872.6	28,888.1	33,263.7	36,377.6

Per-share Performance					
(KRW)	12/08A	12/09A	12/10A	12/11F	12/12F
EPS	30,531	28,243	49,489	45,176	45,235
Adj. EPS	32,001	30,367	50,600	44,964	44,942
BPS	69,131	134,575	190,421	232,657	274,930
SPS	270,007	278,187	294,805	344,588	376,440
EBITDAPS	34,171	35,108	51,665	51,474	50,810
GCFPS	24,928	40,215	45,416	41,551	40,985
DPS	3,943	2,792	3,500	3,500	3,500
3yr CAGR of adj. EPS (%)	29.8	12.0	14.0	(1.5)	5.5

Operating Statistics & Ratios					
(%)	12/08A	12/09A	12/10A	12/11F	12/12F
OR growth (%YoY)	28.5	5.9	6.0	16.9	9.2
OP growth (%YoY)	26.0	0.7	54.5	(0.2)	(1.0)
EBITDA growth (%YoY)	21.2	2.7	47.2	(0.4)	(1.3)
NP growth (%YoY)	30.0	(4.9)	75.2	(8.7)	0.1
Adj. NP growth (%YoY)	34.4	(2.4)	66.6	(11.1)	0.0
OP margin	11.1	10.5	15.3	13.1	11.9
EBITDA margin	13.0	12.6	17.5	14.9	13.5
NP margin	11.3	10.2	16.8	13.1	12.0
Adj. NP margin	11.9	10.9	17.2	13.0	11.9

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