

BUY

29 January 2010

Buy
30 Oct 2009Buy
30 Jul 2009

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WHAT'S NEW

Profitability recovery the highlight of 4Q

Hyundai Heavy (HHI) reported a stronger than expected 4Q with ₩5,332bn sales, ₩675bn operating profit and ₩721bn net profit. Its operating margin came in at 12.7% up from 10.7% in 3Q09. The key highlight from the 4Q result is its recovery in shipbuilding profitability and better earnings outlook. HHI's diversified business has allowed it to develop its electro-electric business as a rerating driver in the past two years, besides taking the pressure off having to settle for lower ship prices in the industry's down phase. HHI's new ship orders should pick up on iron ore and heavy plate price hikes in 2Q10. Maintain Buy and ₩300,000 target price.

» Strong figures in 4Q09

» Good stance in holding out for higher new ship prices

» Diversity: another reason for re-rating

» Maintain Buy at ₩300,000 target price

Strong figures in 4Q09

Hyundai Heavy Industries reported strong profitability in 4Q09 at a 12.7% operating margin. Key contribution came from the recovery of margins in its shipbuilding unit. Other units, such as plant engineering, offshore plant and electro electric units showed consistent profitability amid won appreciation.

Margins in HHI's shipbuilding unit have been depressed for the past three quarters, largely hurt by high price steel plate inventories. As lower price steels were consumed, the operating margin started to normalize. We are expecting further margin improvements as the fall in steel prices leads to the fall in other component prices as well. HHI's engine unit, with its dominant global market share of over 30%, continued to show a strong margin at well above 20%.

I M P A C T

Hedge fund investors

Massive discount and pessimism still an overhang on the stock despite its outstanding competitiveness in diverse engineering units. Fully discounted vs. global peers. Stronger profitability will prove its competitiveness.

Long-only investors

Every indicator is guiding to an upward trend in industries where HHI is involved. We are positive on HHI's wait-and-watch strategy on new ship prices ahead of the upcoming recovery, in our view.

Target price **₩300,000**Current price (28 January 2010) **₩194,000**

Upside/downside 54.6%

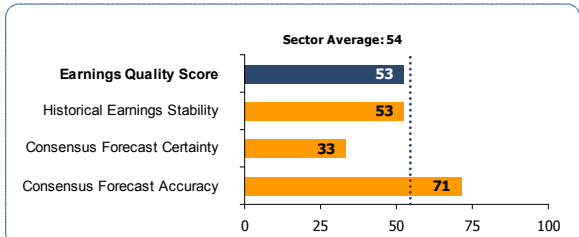
Consensus target price **₩248,000**

Difference from consensus 21.0%

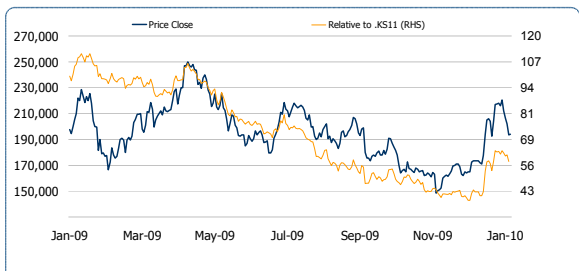
Forecast earnings & valuation

| Fiscal year ending | Dec-08A | Dec-09E | Dec-10E | Dec-11E |
|--------------------|---------|---------|---------|---------|
| Revenue (KRWb) | 19,957 | 22,474 | 25,026 | 26,995 |
| Op EBIT (KRWb) | 2,206 | 2,750 | 3,522 | 3,841 |
| Net income (KRWb) | 2,604 | 2,829 | 3,472 | 3,849 |
| Norm profit (KRWb) | 2,257 | 2,522 | 3,308 | 3,707 |
| EPS (KRW) | 29,693 | 33,183 | 43,522 | 48,780 |
| EPS growth | 30.0% | 11.8% | 31.2% | 12.1% |
| Norm P/E (x) | 6.53 | 5.85 | 4.46 | 3.98 |
| EV/EBITDA (x) | 3.60 | 3.66 | 3.02 | 2.01 |
| Dividend yield | 2.58% | 2.58% | 3.87% | 3.87% |
| P/B (x) | 1.88 | 1.47 | 1.16 | 0.93 |
| ROE | 37.5% | 31.7% | 30.5% | 26.9% |
| Net debt/equity | (43.7%) | (21.5%) | (13.4%) | (36.3%) |
| Cons EPS (KRW) | 29,693 | 29,456 | 37,691 | 38,537 |
| Prev EPS (KRW) | 29,693 | 33,183 | 43,522 | 48,780 |

Earnings quality score



Performance



Trading data

| | | | |
|-----------------------------|-------------------|-----------|------------|
| Market cap (₩bn/US\$m) | 12,069/10,406 | | |
| Shares outstanding | 76.00mn | | |
| Free float | 56% | | |
| 52-week price high/low | ₩148,500 –250,000 | | |
| Daily average turnover (3M) | US\$61.20mn | | |
| Performance | 1M | 3M | 12M |
| Absolute | 12.5% | 14.1% | -1.8% |
| Relative to KOSPI | 16.1% | 13.1% | -42.2% |
| Absolute (US\$) | 14.0% | 15.8% | 17.6% |
| Major shareholders | | | |
| MJ Chung | 10.8% | | |
| Hyundai Mipo | 8% | | |

See the last page of this report for important disclosures

Source for data: Company, Thomson Reuters, Mirae Research estimates

In non-operating items, the company had W150bn gain from its currency hedge position amid won appreciation. As the company booked potential revaluation loss on its currency hedge position previously from won depreciation during 2009, the company had room to restore the loss in the book amid the won's appreciation and reported a currency hedge related gain of W150bn. Its W721bn net profit is 37% higher than consensus.

Figure 1. 4Q09 result summary

| (Wbn) | 4Q09 | 4Q09 consensus | Gap | 3Q09 | QoQ | 4Q08 | YoY |
|---------------|---------|-------------------|--------|---------|--------|---------|--------|
| Sales | 5,331.7 | 5,626.6 | -5.2% | 4,985.8 | 6.9% | 6,050.9 | -11.9% |
| OP | 674.8 | 652.6 | 3.4% | 531.8 | 26.9% | 675.1 | -0.1% |
| OP margin | 12.7% | 11.6% | 1.1%pt | 10.7% | 2.0%pt | 11.2% | 1.5%pt |
| Pretax profit | 845.0 | 700.3 | 20.7% | 698.8 | 20.9% | 990.7 | -14.7% |
| NP | 721.3 | 526.7 | 37.0% | 533.8 | 35.1% | 867.3 | -16.8% |

Source: Company data, Mirae Asset Research

Good stance: very few vessel contracts since October 2008

Since October 2008, HHI has not been aggressive on shipbuilding contracts except for 3 Suezmax tankers and 2 capesize bulk carriers in October 2009. Despite extreme pessimism on the industry in 2009, over 400 vessels were contracted (down from 2,632 in 2008 and 5,169 in 2007). Hyundai Heavy, with a global market share of 13% and the most cost competitive due to its scale and building skills, could have taken significant orders during 2009. Instead, the company kept away from the market, under no pressure to pursue new building contracts on account of its diversified business portfolio, including offshore structures, plant engineering and electro-electric units, and strong operational profitability (over 10% operating margin maintained during 2009).

We expect HHI to start moving on new contracts from 2Q10, after iron ore contract prices rise, followed by a hike in heavy plate prices. The hike will offer Hyundai Heavy good cause to demand higher new building prices and indeed lead this trend afterward. Better grounds for the hike of new building prices are being laid. Actually, all leading indicators of the industry are guiding to an upward trend in new building prices going forward. The biggest driver will be the weakness in the US dollar or an appreciation of the won vs the dollar with another a recovery of steel prices being another trigger. Ship owners and shipping lines are now losing ground to ask for further cuts in ship prices.

Also, prices for secondhand and resale (trade of ships before the delivery from yards) have already recovered and are being traded at a premium over new building prices. Sooner or later, sellable vessels will disappear from the secondhand market, and ship owners will find opportunities from yards.

Diversified business: another reason for rerating

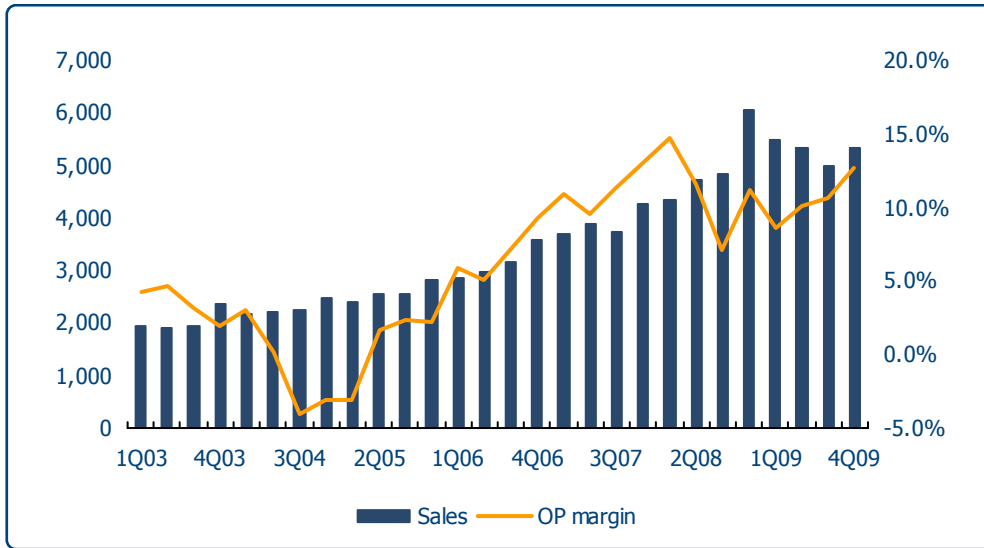
For the past two years, HHI has proved another growth driver in its electro-electric unit, offshore structures and plant engineering units. Electro-electric units have shown over 50% sales growth for the past two years backed by huge replacement demand in US and Europe. Also, its electro electric unit is successfully expanding its scope to wind power and solar power plants as well. Its offshore structure and plant engineering units have enjoyed consistent order flows. Further, the company is expanding its business area to modular plants as exhibited by the Gorgon project. This proves that Hyundai Heavy can expand to the general engineering businesses traditionally dominated by construction and engineering companies.

If fueled by the recovery in the shipbuilding industry, we expect the HHI share to enjoy headroom to be traded at even higher valuations than before.

Maintain Buy at W300,000 target price

By far, the highlight of Hyundai Heavy's 4Q09 result has been its outstanding skill in the shipbuilding industry as exhibited by its strong profitability relative to peers. Supported by potential regulations on greenhouse gas emission controls (see our 17 December 2009 report), HHI's shipbuilding skills will be its crowning feature once again. We are maintaining our Buy recommendation on the stock at a W300,000 target price.

Figure 2. Sales and OP margin trends



Source: Company data, Mirae Asset Research

Summary financial statements

Profit & Loss

| (KRWb) | Dec-07A | Dec-08A | Dec-09E | Dec-10E | Dec-11E |
|--------------------------|---------------|---------------|---------------|---------------|---------------|
| Revenue | 15,533 | 19,957 | 22,474 | 25,026 | 26,995 |
| Cost of goods sold | (12,976) | (16,812) | (18,670) | (20,352) | (21,973) |
| Gross profit | 2,557 | 3,145 | 3,804 | 4,674 | 5,022 |
| SG and A | (806) | (939) | (1,054) | (1,153) | (1,181) |
| Op profit | 1,751 | 2,206 | 2,750 | 3,522 | 3,841 |
| Op EBITDA | 2,143 | 2,597 | 3,203 | 4,026 | 4,343 |
| Depreciation | (352) | (347) | (382) | (431) | (428) |
| Amortisation | (40) | (43) | (71) | (74) | (74) |
| Op EBIT | 1,751 | 2,206 | 2,750 | 3,522 | 3,841 |
| Net interest | 188 | 273 | 382 | 414 | 550 |
| Associates and JCEs | - | - | - | - | - |
| Other income | 101 | 818 | 327 | 363 | 385 |
| Net exceptional income | - | - | - | - | - |
| Profit before tax | 2,040 | 3,297 | 3,459 | 4,299 | 4,776 |
| Tax | (658) | (693) | (630) | (827) | (927) |
| Post-tax profit | 1,381 | 2,604 | 2,829 | 3,472 | 3,849 |
| Minorities | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| Net income | 1,381 | 2,604 | 2,829 | 3,472 | 3,849 |
| Norm profit | 1,736 | 2,257 | 2,522 | 3,308 | 3,707 |
| Dividends | (467) | (300) | (380) | (570) | (570) |
| Retained earnings | 915 | 2,305 | 2,449 | 2,902 | 3,279 |

Source: Company data, Mirae Asset Research estimates

Cashflow

| (KRWb) | Dec-07A | Dec-08A | Dec-09E | Dec-10E | Dec-11E |
|-----------------------------|----------------|----------------|----------------|----------------|----------------|
| Op EBITDA | 2,143 | 2,597 | 3,203 | 4,026 | 4,343 |
| Decrease in working capital | 2,595 | 491 | (490) | (212) | 1,305 |
| Other operating cashflow | 93 | 2,738 | (1,025) | (1,029) | (34) |
| Operating cashflow | 4,831 | 5,826 | 1,688 | 2,786 | 5,613 |
| Tax paid | (658) | (693) | (630) | (827) | (927) |
| Net interest | 188 | 273 | 382 | 414 | 550 |
| Dividends received | (749) | (465) | (543) | (651) | (586) |
| Cashflow | 3,612 | 4,942 | 898 | 1,722 | 4,651 |
| Capital expenditure | (960) | (1,856) | (1,763) | (1,234) | (1,234) |
| Net acquisitions | - | - | - | - | - |
| Net investments | (263) | (2,626) | (175) | (184) | (193) |
| Other investing cashflow | - | - | - | - | - |
| Investing cashflow | (1,222) | (4,482) | (1,938) | (1,418) | (1,427) |
| Dividends paid | (467) | (300) | (380) | (570) | (570) |
| Increase in equity | - | - | - | - | - |
| Increase in debt | 2 | (186) | 500 | (101) | (81) |
| Other financing cashflow | (0) | 0 | - | (0) | (0) |
| Financing cash flow | (465) | (485) | 120 | (671) | (651) |
| Beginning cash | 1,276 | 3,611 | 2,446 | 2,328 | 1,911 |
| Total cash generated | 1,925 | (25) | (920) | (366) | 2,573 |
| Forex effects | - | - | - | - | - |
| Ending cash | 3,200 | 3,586 | 1,526 | 1,962 | 4,484 |

Source: Company data, Mirae Asset Research estimates

Balance Sheet

| (KRWb) | Dec-07A | Dec-08A | Dec-09E | Dec-10E | Dec-11E |
|--------------------------------------|---------------|---------------|---------------|---------------|---------------|
| Current assets | 8,500 | 12,618 | 10,088 | 10,044 | 13,660 |
| Cash and equivalents | 3,611 | 2,446 | 2,328 | 1,911 | 5,544 |
| Receivables | 2,922 | 4,723 | 4,260 | 4,700 | 4,682 |
| Inventories | 1,119 | 2,263 | 1,815 | 1,979 | 1,979 |
| Other current assets | 848 | 3,185 | 1,685 | 1,455 | 1,455 |
| Non current assets | 8,325 | 12,663 | 14,708 | 16,567 | 17,313 |
| Net operating fixed assets | 4,969 | 6,190 | 7,478 | 8,458 | 8,373 |
| Interest in associates | 2,248 | 2,713 | 3,255 | 3,906 | 4,492 |
| Other non-current assets | 1,108 | 3,760 | 3,974 | 4,203 | 4,448 |
| Total assets | 16,824 | 25,280 | 24,796 | 26,611 | 30,973 |
| Current liabilities | 10,888 | 16,474 | 13,673 | 13,815 | 15,086 |
| Payables | 1,618 | 2,518 | 1,804 | 1,945 | 1,945 |
| ST debt | 187 | - | 101 | 81 | 64 |
| Other current liabilities | 9,083 | 13,956 | 11,769 | 11,789 | 13,076 |
| Total non-current liabilities | 445 | 3,211 | 2,625 | 1,561 | 1,514 |
| LT debt | 2 | 3 | 403 | 322 | 258 |
| Other non-current liabilities | 443 | 3,208 | 2,223 | 1,239 | 1,256 |
| Total liabilities | 11,333 | 19,685 | 16,298 | 15,376 | 16,600 |
| Issued capital | 380 | 380 | 380 | 380 | 380 |
| Share premium reserve | 1,863 | 1,863 | 1,863 | 1,863 | 1,863 |
| Reserves/Adjustments | 909 | 956 | 956 | 956 | 956 |
| Retained earnings | 2,867 | 4,657 | 6,799 | 9,537 | 12,674 |
| Minorities | - | - | - | - | - |
| Other equity | (527) | (2,260) | (1,500) | (1,500) | (1,500) |
| Shareholders' equity | 5,492 | 5,595 | 8,498 | 11,235 | 14,373 |

Source: Company data, Mirae Asset Research estimates

Key Ratios

| | Dec-07A | Dec-08A | Dec-09E | Dec-10E | Dec-11E |
|---------------------------|---------|---------|---------|---------|---------|
| Net revenue growth | 23.7% | 28.5% | 12.6% | 11.4% | 7.9% |
| Gross profit growth | 61.7% | 23.0% | 21.0% | 22.9% | 7.4% |
| Operating profit growth | 99.2% | 26.0% | 24.6% | 28.1% | 9.1% |
| EBITDA growth | 64.0% | 52.2% | 3.4% | 24.3% | 7.7% |
| EPS growth | 143.5% | 30.0% | 11.8% | 31.2% | 12.1% |
| Norm BPS growth | 35.4% | 30.5% | 27.3% | 27.4% | 24.6% |
| Gross margin | 16.5% | 15.8% | 16.9% | 18.7% | 18.6% |
| Operating margin | 11.3% | 11.1% | 12.2% | 14.1% | 14.2% |
| EBITDA margin | 14.4% | 17.1% | 15.7% | 17.5% | 17.5% |
| EBIT margin | 11.9% | 15.2% | 13.7% | 15.5% | 15.7% |
| Net income margin | 8.9% | 13.1% | 12.6% | 13.9% | 14.3% |
| ROE | 26.4% | 37.5% | 31.7% | 30.5% | 26.9% |
| ROA | 9.3% | 12.4% | 11.3% | 13.5% | 13.4% |
| Net debt/equity | (62.3%) | (43.7%) | (21.5%) | (13.4%) | (36.3%) |
| Interest cover ratio | 153.5 | 340.9 | 161.3 | 115.5 | 138.2 |
| Dividend payout ratio | 33.8% | 11.5% | 13.4% | 16.4% | 14.8% |
| Inventory days | 31.48 | 49.27 | 35.49 | 35.49 | 32.87 |
| Account receivable days | 68.65 | 86.62 | 69.18 | 68.55 | 63.30 |
| Account payable days | 45.50 | 54.81 | 35.27 | 34.89 | 32.32 |
| Reported EPS (KRW) | 18,177 | 34,269 | 37,223 | 45,682 | 50,647 |
| EPS (KRW) | 22,843 | 29,693 | 33,183 | 43,522 | 48,780 |
| Reported BPS (KRW) | 79,190 | 103,365 | 131,548 | 167,570 | 208,850 |
| Norm BPS (KRW) | 79,190 | 103,365 | 131,548 | 167,570 | 208,850 |
| DPS (KRW) | 7,500 | 5,000 | 5,000 | 7,500 | 7,500 |
| Cashflow per share (KRW) | 47,521 | 65,023 | 11,813 | 22,659 | 61,194 |
| Reported P/E (x) | 10.67 | 5.66 | 5.21 | 4.25 | 3.83 |
| Norm P/E (x) | 8.49 | 6.53 | 5.85 | 4.46 | 3.98 |
| P/B (x) | 2.45 | 1.88 | 1.47 | 1.16 | 0.93 |
| P/CF | 4.08 | 2.98 | 16.42 | 8.56 | 3.17 |
| EV/EBITDA (x) | 5.05 | 3.60 | 3.66 | 3.02 | 2.01 |
| EV/Operating Cashflow (x) | 2.34 | 2.11 | 7.65 | 4.75 | 1.70 |
| EV/Sales (x) | 0.73 | 0.62 | 0.57 | 0.53 | 0.35 |
| Dividend yield | 3.87% | 2.58% | 2.58% | 3.87% | 3.87% |

Source: Company data, Mirae Asset Research estimates

Recommendations

By stock (12 months)

Buy: A target price + 10% or more above the current price,
Hold: Target price within - 10% to +10% of the current price
Reduce: A target price of -10% or less below the current price

By industry

Overweight: over +10% of the current industry index
Neutral: -10% to +10% of the current industry index
Underweight: -10% or less than the current industry index

Earnings quality score

Earnings Quality Score = 0.70*(Historical Earnings Stability) + 0.15*(Consensus Forecast Certainty) + 0.15*(Consensus Forecast Accuracy)

1. Historical Earnings Stability

- The variability of the net profit growth rate (YOY) over the last 20 quarters was translated into percentage terms.
- Earnings growth variability was calculated based on MAD (Median Absolute Deviation), rather than SD (Standard Deviation) in order to minimize distortion from outliers.
- The lower the earnings growth variability, the higher this indicator.

2. Consensus Forecast Certainty

- The gap between analysts' views on 12-month forward EPS was translated into percentage terms.
- The gap is calculated by dividing the SD of 12-month forward EPS with the average value.
- The narrower the gap is, the higher this indicator.

3. Consensus Forecast Accuracy

- The median value of absolute EPS surprise over the last 3-year was translated into percentage terms.
- EPS surprise was calculated based on 'the actual figure at the end of the year / the consensus estimate at the beginning of the year - 1'.
- The lower the absolute EPS surprise, the higher this indicator.

* Reference

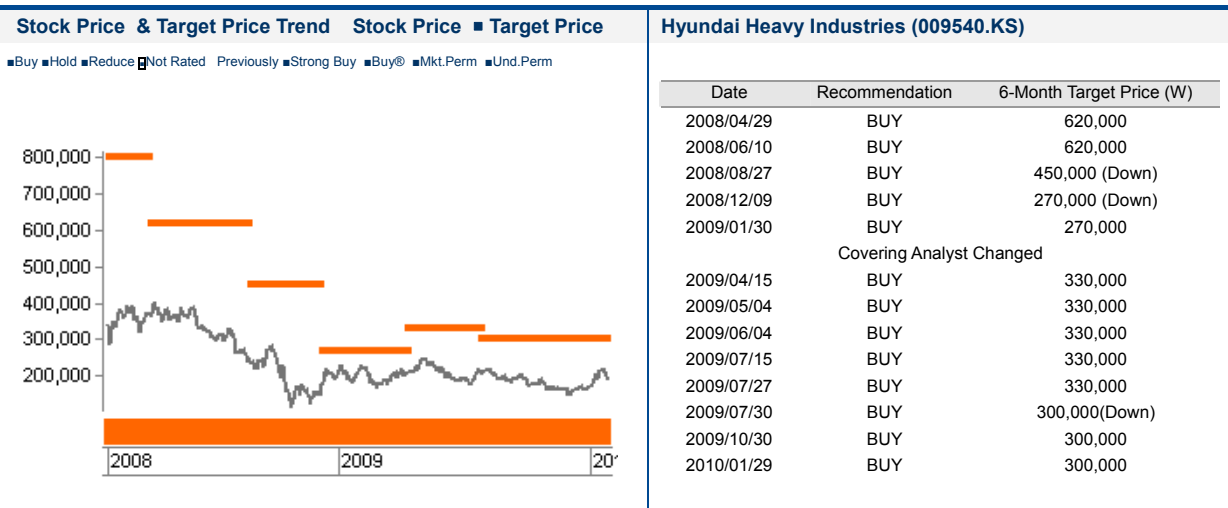
- 1) Consensus Forecast Certainty and Consensus Forecast Accuracy were applied only to companies with more than 5 years of EPS estimates.
- 2) We gave the average score of 50 to cases in which the aforementioned indicators could not be produced.

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[Analyst: Sokje Lee, Seohee Kim]

| Stock | Analyst | Type | Securities Held by the Analyst | | Purchase Date | Holdings of share of over 1% | Participation in Issuance of Securities | Involvement with Affiliates | Treasury Stock Held |
|-------|---------|------|--------------------------------|----------------|---------------|------------------------------|---|-----------------------------|---------------------|
| | | | Number of Shares | Purchase Price | | | | | |
| N/A | | | | | | | | | |



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