



Der Pao Construction (2523 TT)

Not rated

Construction

Company Update

ML Research Team

Non-Tech Analyst

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Recommendation

NR

Date: 31 March 2005

Share Price (NT\$): 8.13

Price Target (NT\$): NA

Percent Change: NA

52-wk range (NT\$): 15.90-6.65

TWSE: 6005.88

Company Data

Capital Size (NT\$): 4.36bn

Market Cap (NT\$): 3.54bn

Market Cap (US\$): 112.5mn

Outstanding Shrs: 435.9mn

Free Floating Shrs: 44.3mn

PER ('05E): 12.91x

PBR ('05E): 0.71x

Foreign Ownership: 10.27%

Major Shareholder: Jinshiang Investment 8.03%

Performance

Absolute (11.15) (21.83) 0.99

Relative to TAIEX (8.16) (20.09) (1.70)

Key Changes

Recommendation NR NA

Price Target (NT\$) NA NA

Revenue (NT\$bn) 8.95 NA

Gross Margin (%) 6.42 NA

Oper. Margin (%) 4.78 NA

EPS (NT\$) 0.63 NA

Price Catalysts (+,-)

(+) Suspension rights lifted

(-) Insufficient backlog orders compared to peers

Related Research

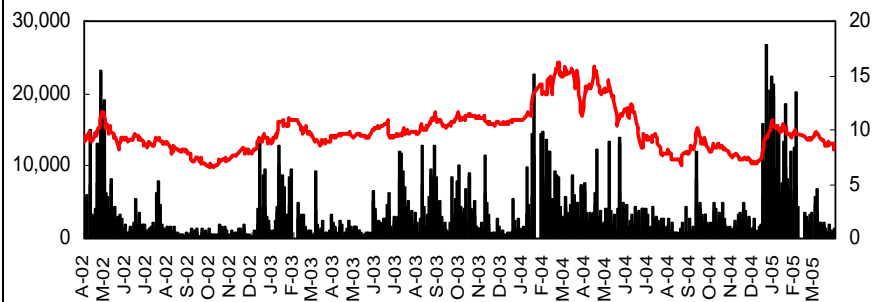
KSECO (5521 TT) Feb 21, '05

Huaku Construction (2548 TT) Jan 13, '05

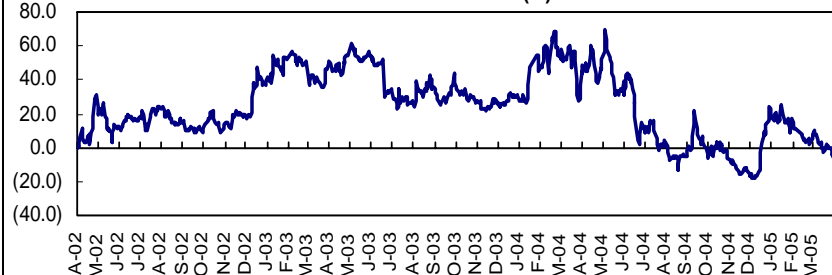
No catalysts in 2005

- **Sluggish 2004 performance.** Der Pao recorded 2004 sales of NT\$9.47bn, down 21.3% YoY, and earnings of NT\$345mn, suggesting an EPS of NT\$0.79. Der Pao's management attributes the worse-than-expected performance as a result of lower than estimated increase in new project values.
- **Suspension of bidding rights weighed heavily on Der Pao.** Der Pao was previously penalized by the government for construction delays and therefore cannot bid for government infrastructure projects for one year. Over the past few months, this issue had weighed heavily on the company's future prospects and the share price.
- **2005 performance still in low levels.** With a low backlog order on hand and constraints to bidding rights, we believe Der Pao's 2005 performance should see another decline, with sales reaching NT\$8.95bn, down 5.5% YoY, and earnings of NT\$275mn, down 20.1% YoY, suggesting an EPS of NT\$0.63.
- **No stimulus in 2005.** Der Pao historically traded between 0.55-1.30x PBR and is currently trading at 0.71x our 2005 estimated BVPS of NT\$11.4. Due to (1) consistent infrastructure spending from the government, and (2) a good reputation in the market, we believe Der Pao's performance would eventually pick up in the future. Nonetheless, Der Pao's (1) suspension of bidding rights for infrastructure projects, (2) a relatively small backlog order compared to peers, and (3) continued sluggish performance in 2005, are the biggest concerns.

Average daily volume ('000, LHS) and share price (NT\$, RHS)



Relative to TAIEX (%)



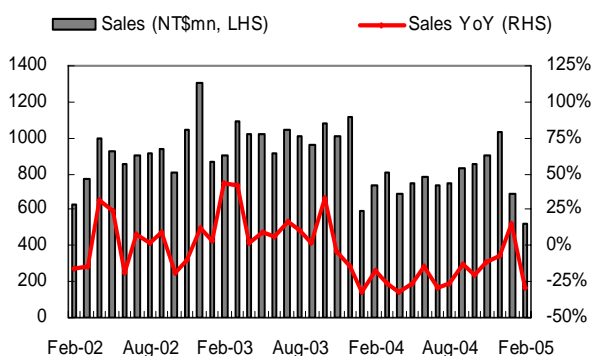
Investment Keynotes

A retrospection: sluggish 2004 sales

Der Pao recorded 2004 sales of NT\$9.47bn, down 21.3% YoY, and earnings of NT\$345mn, suggesting an EPS of NT\$0.79. The company's 2004 sales reached 90.2% of its full-year guidance and earnings reached 82.9%. Der Pao guides 2004 sales of NT\$10.5bn and earnings of NT\$416mn, suggesting an EPS of NT\$0.95. Der Pao's management attributes worse than expected performance as a result of lower than estimated increase in new project values.

At present stages, Der Pao's revenue is 90% generated from government infrastructure projects (public sector) and 10% earned by private sector cases. In addition, up until February 2005 results, Der Pao has over NT\$10bn of backlog orders in hand.

Figure 1: Der Pao's monthly sales and MoM growth



Source: TEJ; MasterLink Securities

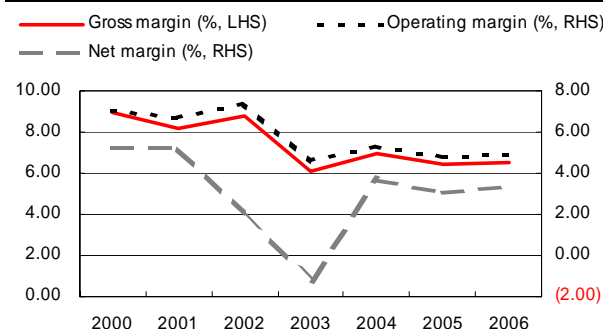
Improving margin in 2004

Compared to 2003's gross margin of 5.67%, Der Pao's 2004 gross margin surged 1.3ppt to nearly 7.0%. A track of historical records show that the company was plagued by rising raw material cost in 2H03 and in 1H04 since most of the sales in this time period were generated from contracts signed in 2002 and did not reflect the current material cost increases. Gross margin dropped to 5.1% in 1H04, receding 2.8ppt YoY. Starting from 2H04, Der Pao's sales, booked on last year's newly acquired contracts, with an average gross margin of 9-11%, substantially improved the company's 2004 gross margin; generally speaking, the company books 6-10% of the new contracts as sales revenue for the first year, and 40% for the second, 40-45% for the third, and 5-14% for the fourth.

Moreover, Der Pao also received subsidies from

government infrastructure projects; the rebate was paid out by the government to partially reflect and subsidize construction companies for the surging raw material prices in 2003 and 2004. To the best of our understanding, Der Pao received over NT\$400mn as subsidy from the government in 2004.

Figure 2: Der Pao's margin changes

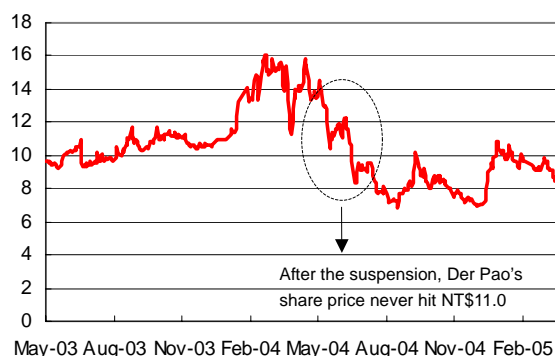


Source: TEJ; MasterLink Securities

Government penalization is woes for Der Pao

Back in May 2004, Der Pao was penalized by the government for delays pertaining to Tainan airport runway construction and therefore could not bid for government infrastructure construction projects for a full year, which weighed heavily on its share price. Der Pao filed a lawsuit against the government since they believe the slowdown was not their responsibility. Der Pao would not see the verdict until the beginning of May 2005, and the company's management believes the outcome should favor them and alleviate them from such constraint.

Figure 3: Der Pao's share price after suspension rights



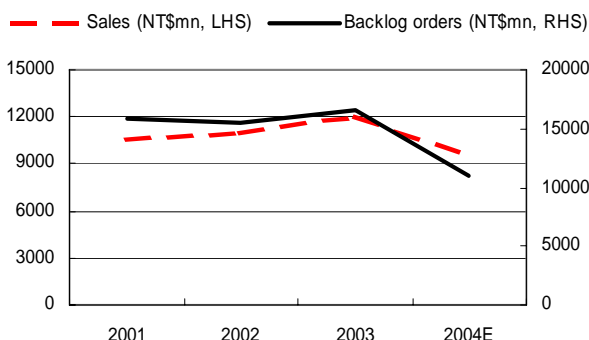
Source: TEJ; MasterLink Securities

2005 performance still remain in low levels

As stated, Der Pao was bitterly struck by the suspension of bidding rights, and therefore, the company had not been able to increase its backlog orders in 2004; although efforts were made to acquire more private sector cases, the results were not satisfactory. Backlog orders for constructors should be seen as a guarantee of revenue in the future, especially for companies that specialize in government-backed infrastructure projects. Looking forward, Der Pao should see chances of winning the lawsuit, but by then, many important infrastructure projects could have been taken up by competitors. In addition, Der Pao's subsidiaries in 2005, according to the company's management, would unlikely top 2004's level of NT\$400mn.

To sum up, we believe Der Pao's 2005 performance should see another decline, with sales reaching NT\$8.95bn, down 5.5% YoY, and earnings of NT\$275mn, down 20.1% YoY, suggesting an EPS of NT\$0.63.

Figure 4: Der Pao's sales vs. backlog orders

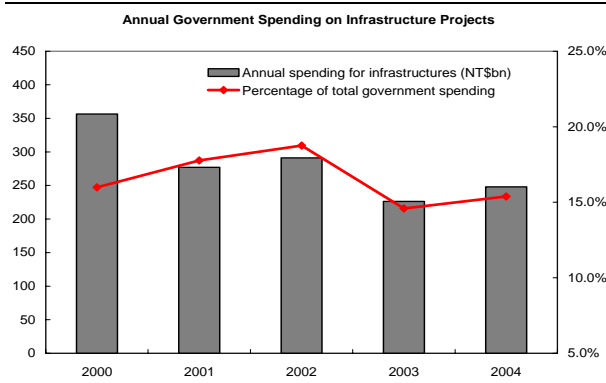


Source: Company data; MasterLink Securities

The bright news: more infrastructure projects in 2005

On the demand side, there are more infrastructure project opportunities for Der Pao in 2005. For the past 10 years, the government's infrastructure spending had been relatively stable, ranging from 3.5-5.0% of Taiwan's annual GDP. This would translate into an annual infrastructure spending of NT\$250-400bn in the domestic market.

Figure 5: Government spending on infrastructure projects



Source: TEJ; MasterLink Securities

This year, however, government infrastructure could possibly exceed NT\$450-500bn, which is largely emphasized by the construction of more MRT lines in Taipei and its suburbs. The earliest bid for infrastructure projects would be the MRT Hsinyi line in February 25, 2005, and the peak for other infrastructure plans should come in at 2H05. In 2005, total major infrastructure projects could exceed NT\$196bn. This should help the construction companies and Der Pao to improve sales for the next few years.

Again, Der Pao's biggest concern would be its ability to bid for new government projects; if the lawsuit, by any chance, take a longer than expected time to be finalized, Der Pao would not be able to participate in the infrastructure projects.

Figure 6: Upcoming major infrastructure projects in 2005

Project	Bid date	Project value (NT\$mn)
MRT Hsinyi line	Feb 25, 2005	11,600
MRT Nankang line	3Q05 / 4Q05	25,000
MRT Taipei County lines	3Q05 / 4Q05	20,000
Suhua Highway	2Q05 / 3Q05	60,000
MRT Airport line (1 st stage)	3Q05 / 4Q05	20,000
MRT Airport line (2 nd stage)	3Q05 / 4Q05	20,000
MRT Airport line (3 rd stage)	4Q05 / 1Q06	20,000
MRT Airport line (4 th stage)	4Q05 / 1Q06	20,000
Total		196,600

Source: Company data; MasterLink Securities

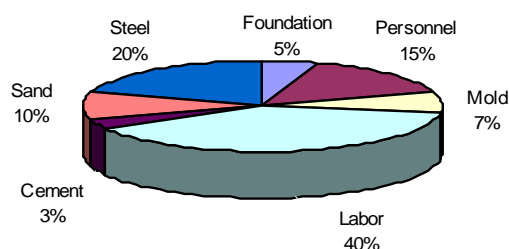
Property developers v.s. constructors

Thanks to government subsidies and the possibility of dropping raw material prices in 2H05 and 2006, we believe that constructors will benefit more than property developers. Since material costs usually account for 40-50% of total costs for constructors, the dropping

material costs should help constructors to improve their gross margins. For property developers, land cost usually accounts for 50-70% of total costs thus material cost fluctuations are less important to them.

Except for a few property developers that could probably enjoy sustained sales and earnings growth in 2005 and 2006, constructors, at this turning point, should be better-off in the future with huge amounts of infrastructure projects coming up in 2005, which would guaranteed stable performance in the future. Therefore, switching from property developers to constructors, in our view, is a smarter play for the next few years.

Figure 7: Der Pao's cost structure (based on 3Q04 results)

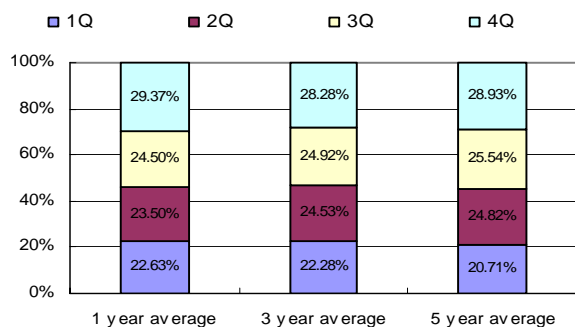


Source: Company data; MasterLink Securities

Light season on the way

If Der Pao could win the lawsuit against the government, this would definitely add positive sentiment to the company's share price. Nonetheless, Der Pao's historical light season is also paving the way; a retrospection reveals that approximately 55% of the company's total sales per annum are concentrated in 2H. In addition, Der Pao's share price also highly correlates with its sales and seasonal pattern.

Figure 8: Der Pao's seasonal sales pattern



Source: TEJ; MasterLink Securities

Peer comparison

As mentioned, backlog orders for constructors should be seen as a guarantee of revenue in the future. Once the orders are booked into accounts by the percentage of completion method, a company with an abundance of backlog orders and a small capital should result in a strong sales and earnings growth for the company in the future.

An inspection of constructors in the market shows that Der Pao's potential performance growth is relatively small compared to peers; the aftermath would be another sluggish performance for Der Pao in 2005.

Figure 9: Comparison of backlog orders (December 2004 results)

Ticker	Company	Backlog orders (NT\$m)	Shares Outstanding A ÷ B	
			A (mn)	B
2515	BES Engineering	32,200	1,450.0	22
2523	Der Pao	11,000	435.9	25
2526	CEC	19,500	805.1	24
2543	Huang Chang	15,000	106.9	140
5521	KSECO	36,383	187.1	194
9933	CTCI	67,000	58.0	116

Source: Company data; MasterLink Securities

In addition, Der Pao's sales and earnings growth momentum should also be worse than its peers in 2005.

Figure 10: Peer comparison table

Ticker	Company	Sales (NT\$m)			EPS (NT\$)		
		2004E	2005E	YoY	2004E	2005E	YoY
2515	BES Engineering	10853	11321	4.3%	0.24	0.27	12.5%
2523	Der Pao	9466	8947	-5.5%	0.79	0.63	-20.1%
2526	CEC	18371	13296	-27.6%	1.87	1.06	-43.3%
2543	Huang Chang	4459	5417	21.5%	0.96	1.95	145.9%
5521	KSECO	3658	6156	68.3%	2.95	3.54	33.9%
9933	CTCI	13545	15008	10.8%	0.82	1.31	59.8%

Source: TEJ; MasterLink Securities

Valuations and recommendation

No stimulus in 2005

Der Pao historically traded between 0.55-1.30x P/B and is currently trading at 0.71x our 2005 estimated BVPS of NT\$11.4. Due to (1) consistent infrastructure spending from the government, and (2) a good reputation in the market (Der Pao was responsible for projects such as Yulio Tunnel, Yunghlin expressway, Makung airport, Chungtao power plant, etc.), we believe Der Pao's performance would eventually pickup in the future.

Nonetheless, Der Pao's (1) suspension of bidding rights for infrastructure projects, (2) a relatively small backlog order compared to peers, and (3) continued sluggish performance in 2005, are the biggest concerns for Der Pao.

Figure 11: Der Pao's P/B band graph



Source: TEJ; MasterLink Securities

Income Statement (Der Pao Construction, 2523 TT)					NT\$m
Year to December	2002	2003	2004E	2005E	2006E
Net Sales	10,918	11,970	9,466	8,947	9,175
Operating Cost	9,984	11,292	8,806	8,372	8,580
Unrealized Sales to Subsidiaries	28	55	0	0	0
Gross Profits	961	733	661	575	595
Operating Expenses	157	187	155	147	150
Selling	0	0	0	0	0
Administration	0	0	0	0	0
R&D	0	2	0	0	0
Operating Profits	804	547	506	428	445
Total non-op. Profits	-358	-560	-58	-76	-59
Net Interest	-52	-75	-110	-131	-118
Investment income	-340	-525	52	55	59
FX Gains (Loss)	-1	0	0	0	0
Others	35	40	0	0	0
Pretax Profits	446	-14	447	352	386
Tax	215	132	103	77	85
Net Profits	231	-146	345	275	301
EPS (NT\$)	0.60	-0.38	0.79	0.63	0.69
Adj. EPS (NT\$)	0.53	-0.34	0.79	0.63	0.69
Shares Outstanding (mn shrs)	387	387	436	436	436
Depreciation & Amortization	13	19	20	21	21
EBITDA	573	114	603	531	550
Year-on-year change (%)					
Sales	3.65	9.64	(20.92)	(5.49)	2.55
Gross Profits	11.55	(23.71)	(9.88)	(13.05)	3.58
Operating Profits	14.39	(31.99)	(7.47)	(15.37)	3.93
Pretax Profits	(37.40)	(103.11)	(3328.45)	(21.21)	9.50
Net Profits	(57.75)	(163.24)	(335.80)	(20.12)	9.34
Ratios (%)					
ROE	4.32	(3.04)	6.99	5.52	5.88
ROA	2.20	(1.46)	3.33	2.73	2.99
Gross Margin	8.80	6.13	6.98	6.42	6.49
Operating Margin	7.36	4.57	5.34	4.78	4.85
Net Margin	2.12	(1.22)	3.64	3.08	3.28
EBITDA Margin	5.25	0.95	6.37	5.93	5.99

Income Statement (Der Pao Construction, 2523 TT)					NT\$m
Year-end	2002	2003	2004E	2005E	2006E
Cash	375	373	408	339	276
Marketable Securities	62	37	157	287	287
AR and NR	2,447	2,628	2,705	2,354	2,414
Inventory	3,770	3,504	3,313	3,131	2,936
Other	2,400	2,614	2,614	2,614	2,614
Current Assets	9,054	9,155	9,196	8,725	8,527
Long-term Investments	931	306	415	455	455
Fixed Assets	456	504	676	850	1,025
Other Assets	63	50	50	50	50
Total Assets	10,505	10,015	10,337	10,080	10,057
ST Borrowings	1,728	1,265	2,045	1,845	1,645
AP and NP	2,451	2,666	2,083	1,968	2,018
Other ST Liabilities	883	1,232	1,232	1,232	1,232
Other Liabilities	91	47	47	47	47
LT Debt	0	0	0	0	0
Total Liabilities	5,153	5,210	5,407	5,092	4,942
Common Shares	4,359	4,359	4,359	4,359	4,359
Other Shareholders' Equity	993	446	572	630	756
Total Equity	5,352	4,805	4,931	4,989	5,115
Total Liab. & Equity	10,505	10,015	10,338	10,081	10,058
Ratios					
Debt/Equity (%)	42.33	44.42	55.95	50.08	46.16
Current Ratio (%)	178.86	177.30	171.58	172.93	174.17
Quick Ratio (%)	104.38	109.45	109.76	110.87	114.20
Sales/Fixed Assets (%)	2,392.42	2,375.76	1,400.63	1,052.68	895.17
Inventory Turns (x)	3	3	3	3	3
Receivable Turns (x)	4.46	4.55	3.50	3.80	3.80
Collection Period (Days)	81.81	80.14	104.29	96.05	96.05

Income Statement (Der Pao Construction, 2523 TT)					NT\$m
Year to December	2002	2003	2004E	2005E	2006E
Cash flow from operating activities	(271)	832	(164)	714	507
Net profits	231	(146)	345	275	301
Plus depreciation	13	19	20	21	21
Minus associates; plus dividends	87	57	(59)	0	0
Other adjustments	(602)	903	(470)	418	186
Cash flow from investing activities	(0)	79	868	(365)	(196)
Purchase of fixed assets (CAPEX)	(118)	(188)	(192)	(195)	(196)
Proceeds from sales of fixed assets	0	11	0	0	0
Investment in associates	(1)	(12)	(50)	(40)	0
Sale of investments	0	120	1,230	0	0
Other adjustments	118	147	(120)	(130)	0
Cash flow from financing activities	200	(913)	888	(418)	(374)
Short-term borrowings	652	(463)	780	(200)	(200)
Long-term loans	0	0	0	0	0
Payment on long-term loans	0	0	0	0	0
Dividend paid	(436)	(436)	(218)	(218)	(174)
Shares issued	0	0	0	0	0
Other adjustments	(16)	(14)	326	0	0
FX effects	0	0	0	0	0
Net changes in cash	(71)	(2)	1,592	(69)	(63)
Cash at the end of the period	375	373	408	339	276

MasterLink Securities – Stock Rating System

BUY: Total return expected to appreciate 15% or more over a 12-month period.

HOLD: Total return expected to be between 15% to –15% over a 12-month period.

SELL: Total return expected to depreciate 15% or more over a 12-month period.

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