

**KSECO (5521 TT)****BUY**

Construction

Company Update

ML Research Team**Non-Tech Analyst**

Dave Chiou
886.2.2731 3888 ext. 633
davechiou@masterlink.com.tw
Construction Analyst
Judy Chang

Recommendation

BUY

Date: 21 February 2005
Share Price (NT\$): 16.3
Price Target (NT\$): 20.5
Percent Change: 25.8%
52-wk range (NT\$): 18.8-6.8
TWSE: 6142.78

Company Data

Capital Size (NT\$): 1.9bn
Market Cap (NT\$): 3.1bn
Market Cap (US\$): 96.8mn
Outstanding Shrs: 187.1mn
Free Floating Shrs: 4.10mn
PER ('05E): 4.61x
PBR ('05E): 1.12x
Foreign Ownership: 2.71%
Major Shareholder: B.O.D Mr. Pan 13.29%

Performance

	1-m	3-m	6-m
Absolute	(4.12)	9.76	10.14
Relative to TAIEX	(7.38)	7.73	(2.68)

Key Changes

	Current	Prev.
Recommendation	BUY	NA
Price Target (NT\$)	20.5	NA
Revenue (NT\$bn)	6.2	NA
Gross Margin (%)	12.95	NA
Oper. Margin (%)	8.53	NA
EPS (NT\$)	3.54	NA

Price Catalysts (+,-)

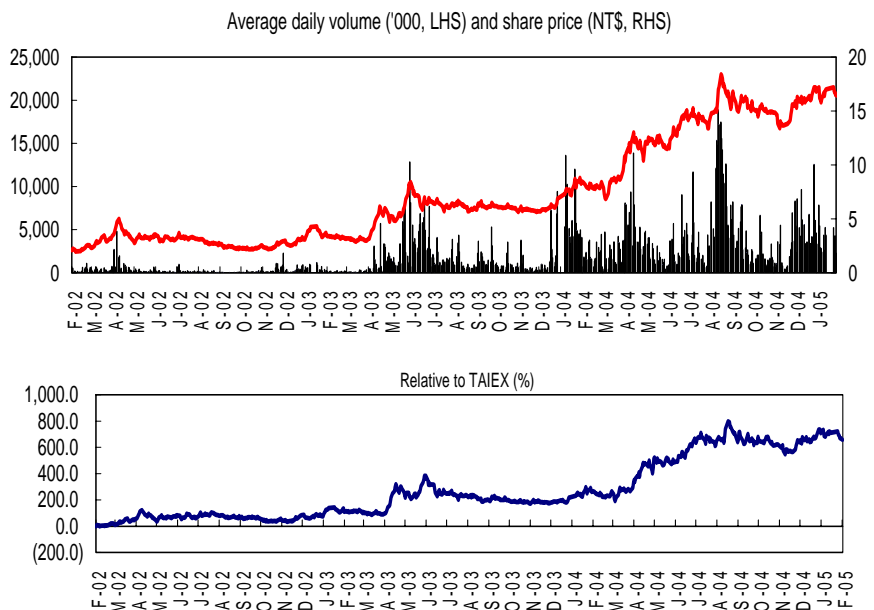
(+) Substantially improved performance in 2005
(+) Acquisition of new orders
(+) Improving cash dividend yield

Related Research

NA

A no-brainer selection

- **Substantially improved performance in 2005.** Thanks to the Mass Rapid Transportation (MRT) Neihu line, KSECO's performance should see a dramatic increase in 2005. KSECO's sales in 2005 should reach NT\$6.2bn, up 68.3% YoY, with earnings of NT\$673mn, up 33.9% YoY, suggesting an EPS of NT\$3.54.
- **Possible acquisition of new orders in 2005.** The MRT extension lines outlines the future prospects of KSECO. If KSECO successfully takes another MRT line's construction project in 2005, then the company's performance in 2006 should see another surge. Combined with the Neihu line, we believe the company's earnings for the next 3-4 years could reach NT\$8.5-9.5bn per annum.
- **Improving cash dividend yield sequentially.** According to KSECO, dividend payout ratio in 2005 should reach at least 70-80% for 2004 earnings, of which 40-50% would be in cash. As such, we believe KSECO would pay out NT\$0.8 per share as cash dividend in 2005, indicating a modest cash dividend yield of 4.9%. Starting from 2006, KSECO would sequentially increase the proportion of cash dividend, and should likely pay out at least 45-50% of total earnings as cash dividend.
- **BUY with a target price of NT\$20.5.** Due to (1) substantially improved performance in 2005, (2) steady growth of sales and earnings in the next 3-4 years (3) possibilities of acquiring new major infrastructure projects, and (4) improving cash dividend yield over time, we have a BUY recommendation for KSECO with a target price of NT\$20.5, based on 1.4x our 2005 estimated BVPS.

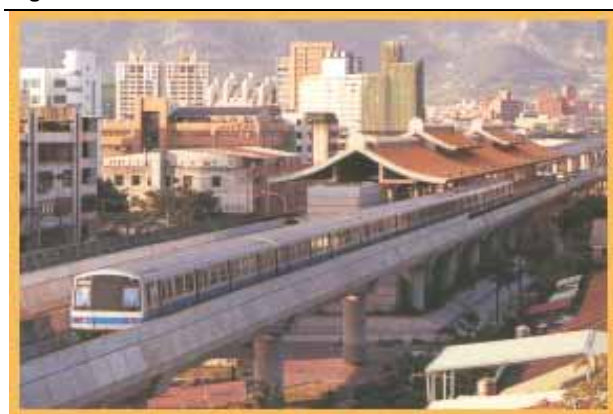


Investment Keynotes

Substantially improved sales in 2005

KSECO currently has the second largest backlog order in Taiwan (contract orders to be finished), reaching NT\$36.4bn, of which 85.3%, or NT\$31.0bn, is contributed by the newly bid Neihu MRT project. Since the Neihu MRT extension line is expected to be completed by 2009, KSECO would be guaranteed stable sales from the MRT Neihu line of at least NT\$4.0-5.0bn for the next few years.

Figure 1: MRT Line



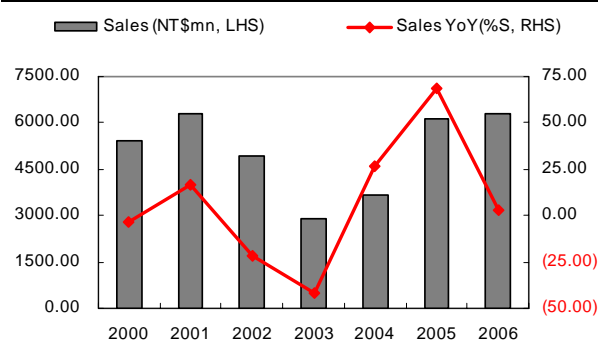
Source: TRTC; MasterLink Securities

As a result, KSECO's sales in 2005 should reach

NT\$6.2bn, up 68.3% YoY, with earnings of NT\$673mn, 33.9% YoY, suggesting an EPS of NT\$3.54. In addition, since a lot of new infrastructure projects are planning to be released in 2005, KSECO's future performance could possibly see a significant increase in 2006.

Conservatively, we did not factor in any new projects in our 2006 forecast. Therefore, KSECO's performance should remain fairly stable in 2006 and sales should reach NT\$6.4bn, up 3.9% YoY, with earnings of NT\$698mn, up 3.8% YoY, suggesting an EPS of NT\$3.28.

Figure 2: KSECO's annual sales and YoY growth



Source: TEJ; MasterLink Securities

Figure 3: KSECO's backlog constructions on hand (December 2004 results)

Project name	Project value (NT\$mn)	Start of construction	Date of completion	Backlog project value (NT\$mn)	Completion percentage
MRT Section CN255	2,643.9	1993/4/19	2000/12/31	0.4	99.98%
Beiyi Highway Nankang to Xidin Section	1,810.8	1994/9/16	2003/1/27	164.3	90.93%
Chunghwa Telecom Building	1,111.3	1997/11/3	2003/10/30	10.7	99.04%
Highway Section C305	1,875.3	1998/8/14	2003/6/15	0	98.25%
Taichung-Binchung Expressway Section C326	2,883.9	2000/2/29	2003/12/7	83.2	100%
Chunghwa Highway	3,539.3	2000/3/9	2004/4/30	42.2	98.81%
Changkai Shek Airport	1,997.7	2001/3/12	2004/7/21	10.5	100%
Beiyi Highway Donshan Bridge	1,664.4	2001/9/12	2005/11/30	532.1	66.86%
MRT Section CK570F (Hsinchuan line)	3,086.1	2002/6/20	2011/2/18	2,344.7	24.02%
MRT Section CB410 (Neihu line)	32,870.0	2003/6/1	2009/7/31	31,019.6	5.62%
Yuchan Highway (tunnel)	1,190.6	2004/1/15	2007/1/15	981.2	17.58%
Dolio Expressway Maintenance	1,150.0	2004/6/10	2006/5/31	1,150.0	0.0%
Chunwha Chemicals Ltd.	54.5	2004/7/19	2007/4/24	44.1	16.37%
Total	55,877.8			36,383.1	

Source: Company data; MasterLink Securities

Figure 4: KSECO's historical backlog orders and sales (December 2004 results)

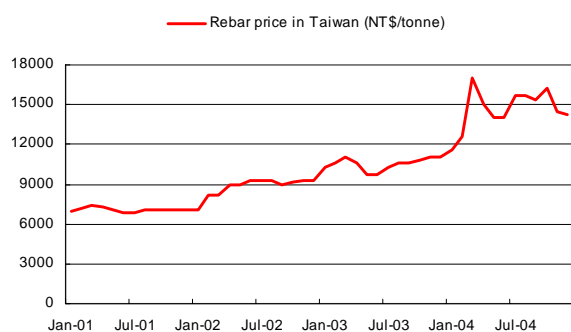
Project name	2000	2001	2002	2003	2004
Total project value (NT\$m)	26,753	28,552	29,634	61,454	55,877
Partial construction billing (NT\$m)	7,789	13,425	11,353	13,346	19,494
Backlog orders (NT\$m)	1,896.4	1,512.7	1,828.1	4,810.8	3,637.6
Sales (NT\$m)	54.30	63.12	49.52	28.91	36.57
Total project value YoY	NA	6.7%	3.8%	107.4%	-9.1%
Backlog orders YoY	NA	-20.2%	20.9%	163.2%	-24.4%
Sales YoY	NA	16.2%	-21.5%	-41.6%	26.5%

Source: Company data; MasterLink Securities

Gross margin sustainable at 12-13%

Historically KSECO had been plagued by low gross margin; KSECO's 2002 gross margin was only 2.7%, and marginally improved to 5.6% in 2003. The company suffered from low gross margin because (1) construction blueprint changes by the government led to unexpected and unwanted additional costs, and (2) sharp increase in raw material prices, especially rebars, which roughly accounts for 10-12% of KSECO's total costs (raw material costs generally account for 70-75% of KSECO's total cost).

Figure 5: Domestic rebar prices



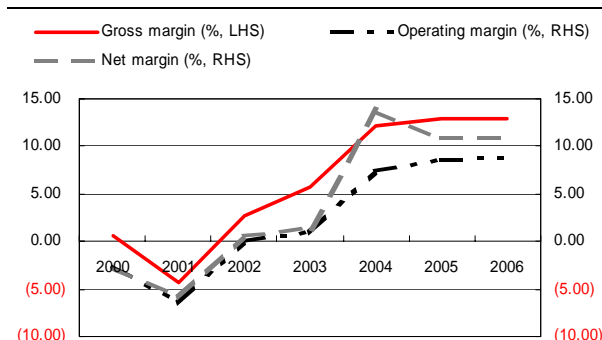
Source: TEJ; MasterLink Securities

Nonetheless, starting from 2004, the company's gross margin improved significantly to 12.2%. KSECO was capable of increasing its gross margin because (1) the company started to file an arbitration against the government and as a result the government had to reimburse KSECO for the incremental costs, and (2) KSECO successfully cut down its raw material costs by signing long term contracts with its vendors such as Tung Ho ((2006 TT, NT\$26.0, BUY) (under review)).

Based on our forecast, KSECO's gross margin has improved 6.6ppt from 2003 figures to 12.2% in 2004; gross margins for 2005 and 2006 should sustain at

12-13%, with operating margins of 8-9% and net margins of 10-11%.

Figure 6: KSECO's margin changes



Source: Company data; MasterLink Securities

More infrastructure plans underway

On the demand side, there are more infrastructure project opportunities for KSECO 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.

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.

Cash dividend yield likely to increase over time

According to KSECO, dividend payout ratio in 2005 should reach at least 70-80% for 2004 earnings, of which 40-50% would be in cash. We believe KSECO would pay out NT\$0.8 per share as cash dividend in 2005, indicating a modest cash dividend yield of 4.9%. Starting from 2006, KSECO would sequentially increase the proportion of cash dividend, and should likely pay out at least 45-50% of total earnings as cash dividend.

Based on company guidance, KSECO would try to increase its total outstanding shares from the current 187mn to 250mn in the next few years. Once KSECO reaches its target then cash dividend payout ratio would come close to 80-90% of total earnings. Therefore, KSECO's proposals to reach the goal include (1) stable stock dividends of NT\$1.0-1.5 per share for the next 3-4 years; if so, KSECO should pay out NT\$1.5 per share as stock dividends for the next 2 years and then convert to a 80-90% cash dividend payout ratio, or (2) issuing another rights issue about NT\$200-250mn in 2005 or 2006 to accelerate the process, and increase its cash dividend payout ratio afterwards.

Peer comparison

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; once the orders are booked into accounts, 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 reveals that KSECO's potential performance growth is the highest among peers. Therefore, we believe this implies that KSECO's sales and earnings would have more positive guarantee in the future.

Figure 11: Comparison of backlog orders (December 2004 results)

Ticker	Company	Backlog orders (NT\$mn)	Shares Outstanding A ÷ B	
			A (mn)	B
5521	KSECO	36,383	187.1	19.4
2515	BES Engineering	32,200	1,450.0	2.2
2526	CEC	19,500	805.1	2.4
2543	Huang Chang	15,000	106.9	14.0
9933	CTCI	67,000	58.0	11.6

Source: Company data; MasterLink Securities

In addition, KSECO's sales and earnings growth

momentum is also more stable than its peers, with sales and earnings improving 68.3% YoY and 33.9% YoY, respectively in 2005.

Figure 12: Peer comparison table

Ticker	Company	Sales (NT\$mn)			EPS (NT\$)		
		2004E	2005E	YoY	2004E	2005E	YoY
5521	KSECO	3658	6156	68.3%	2.95	3.54	33.9%
2515	BES Engineering	10853	11321	4.3%	0.24	0.27	12.5%
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%
9933	CTCI	13545	15008	10.8%	0.82	1.31	59.8%

Source: TEJ; MasterLink Securities

Risk concerns

Neihu line project may limit future growth

Unlike competitors such as BES Engineering (2515 TT, NT\$6.05, NR) and CEC (2526 TT, NT\$15.8, NR), KSECO's relatively smaller size of labor and facilities may hinder the company's ability to take in another big construction project such as the MRT Airport line. Although KSECO's management indicated that they have sufficient labor and facilities to handle another major infrastructure project, we conservatively believe the company would be hindered by their limited resources. Nonetheless, (1) cooperating with other construction companies to bid for the infrastructure and splitting the project, or (2) running around-the-clock shifts as to meet demand should be ways of resolving the issue.

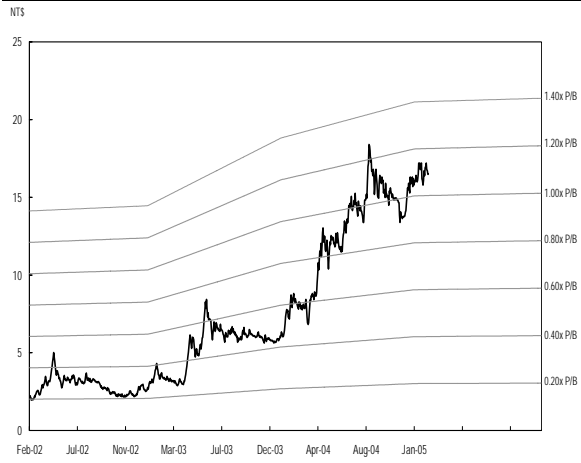
Valuations and recommendation

BUY with a target price of NT\$20.5

Historically KSECO traded between 0.2-1.3x PBR and is currently trading at 1.13x our 2005 estimated BVPS of NT\$14.6. However, KSECO had never enjoyed the prosperous results it is now experiencing. Therefore, we believe the company deserves a even higher PBR.

Due to (1) substantially improved performance in 2005, (2) steady growth of sales and earnings in the next 3-4 years (3) possibilities of acquiring new major infrastructure projects, and (4) improving cash dividend yield over time, we have a BUY recommendation for KSECO with a target price of NT\$20.5, which is based on 1.4x our 2005 estimated BVPS.

Figure 13: KSECO's P/B band graph



Source: TEJ; MasterLink Securities

Income Statement (KSECO, 5521 TT)					NT\$m
Year to December	2002	2003	2004E	2005E	2006E
Net Sales	4,952	2,891	3,658	6,156	6,393
Operating Cost	4,816	2,728	3,213	5,359	5,572
Unrealized Sales to Subsidiaries	0	0	0	0	0
Gross Profits	136	163	445	797	821
Operating Expenses	130	137	173	272	264
Selling	0	0	0	0	0
Administration	130	137	140	142	144
R&D	0	0	0	0	0
Operating Profits	6	26	272	525	556
Total non-op. Profits	26	18	262	215	214
Net Interest	-19	-37	-46	-44	-37
Investment income	-3	6	308	259	251
FX Gains (Loss)	0	0	0	0	0
Others	49	49	0	0	0
Pretax Profits	32	44	534	740	771
Tax	-3	5	32	67	73
Net Profits	34	39	502	673	698
EPS (NT\$)	0.21	0.24	2.95	3.54	3.28
Adj. EPS (NT\$)	0.20	0.23	2.95	3.96	4.11
Shares Outstanding (mn shrs)	162	162	170	190	213
Depreciation & Amortization	66	56	58	61	62
EBITDA	152	158	711	923	955
Year-on-year change (%)					
Sales	(21.54)	(41.61)	26.51	68.30	3.85
Gross Profits	(150.92)	20.05	172.77	79.24	2.97
Operating Profits	(101.39)	368.34	934.23	93.17	6.01
Pretax Profits	(108.53)	39.64	1107.21	38.62	4.15
Net Profits	(109.21)	13.66	1190.20	33.94	3.76
Ratios (%)					
ROE	2.09	2.32	20.69	22.76	20.84
ROA	0.74	0.74	8.63	9.31	9.06
Gross Margin	2.74	5.64	12.16	12.95	12.84
Operating Margin	0.11	0.91	7.43	8.53	8.70
Net Margin	0.69	1.35	13.73	10.93	10.92
EBITDA Margin	3.08	5.47	19.43	14.99	14.94
Balance Sheet (KSECO, 5521 TT)					NT\$m
Year-end	2002	2003	2004E	2005E	2006E
Cash	438	463	486	595	961
Marketable Securities	58	51	51	51	51
AR and NR	1,539	1,237	1,463	2,462	2,557
Inventory	296	400	494	831	863
Other	1,431	2,243	2,243	2,243	2,243
Current Assets	3,762	4,395	4,737	6,183	6,676
Long-term Investments	73	69	320	320	320
Fixed Assets	286	431	382	338	322
Other Assets	494	380	380	380	380
Total Assets	4,615	5,275	5,820	7,222	7,698
ST Borrowings	839	860	860	860	860
AP and NP	1,651	1,488	1,280	2,155	2,238
Other ST Liabilities	422	1,122	1,122	1,122	1,122
Other Liabilities	66	130	130	130	130
LT Debt	0	0	0	0	0
Total Liabilities	2,979	3,600	3,392	4,267	4,350
Common Shares	1,621	1,621	1,810	2,027	2,271
Other Shareholders' Equity	15	54	617	927	1,078
Total Equity	1,636	1,675	2,427	2,955	3,349
Total Liab. & Equity	4,615	5,275	5,819	7,222	7,698
Ratios					
Debt/Equity (%)	50.79	95.38	64.89	49.61	32.85
Current Ratio (%)	129.15	126.64	145.20	149.45	158.19
Quick Ratio (%)	118.99	115.11	130.06	129.36	137.74
Sales/Fixed Assets (%)	1,731.82	671.18	956.40	1,820.20	1,985.14
Inventory Turns (x)	17	7	7	7	7
Receivable Turns (x)	3.22	2.34	2.50	2.50	2.50
Collection Period (Days)	113.40	156.16	146.00	146.00	146.00

Statement of Cash Flows (KSECO, 5521 TT)					NT\$mnn
Year to December	2002	2003	2004E	2005E	2006E
Cash flow from operating activities	(382)	797	(218)	272	716
Net profits	34	39	502	673	698
Plus depreciation	66	56	58	61	62
Minus associates; plus dividends	7	4	(251)	0	0
Other adjustments	(489)	699	(528)	(462)	(44)
Cash flow from investing activities	302	(855)	1,220	(17)	(46)
Purchase of fixed assets (CAPEX)	(20)	(8)	(10)	(17)	(46)
Proceeds from sales of fixed assets	36	7	0	0	0
Investment in associates	0	0	0	0	0
Sale of investments	0	0	1,230	0	0
Other adjustments	286	(853)	0	0	0
Cash flow from financing activities	75	83	250	(145)	(304)
Short-term borrowings	112	21	0	0	0
Long-term loans	0	0	0	0	0
Payment on long-term loans	0	0	0	0	0
Dividend paid	0	0	0	(145)	(304)
Shares issued	0	0	250	0	0
Other adjustments	(37)	62	0	0	0
FX effects	0	0	0	0	0
Net changes in cash	(5)	25	1,252	110	366
Cash at the end of the period	438	463	486	595	961

MasterLink Securities – Stock Rating System

BUY: Total return expected to appreciate 10% or more over a 3-month period.

HOLD: Total return expected to be between 10% to –10% over a 3-month period.

SELL: Total return expected to depreciate 10% or more over a 3-month period.

Additional Information Available on Request

©2004 MasterLink Securities. All rights reserved.

This information has been compiled from sources we believe to be reliable, but we do not hold ourselves responsible for its completeness or accuracy. It is not an offer to sell or solicitation of an offer to buy any securities. MasterLink and its affiliates and their officers and employees may or may not have a position in or with respect to the securities mentioned herein. This firm (or one of its affiliates) may from time to time perform investment banking or other services or solicit investment banking or other business from, any company mentioned in this report. All opinions and estimates included in this report constitute our judgment as of this date and are subject to change without notice. MasterLink has produced this report for private circulation to professional and institutional clients only. All information and advice is given in good faith but without any warranty.