POSCO (PKX)

Updated January 30th, 2019 by Josh Arnold

Key Metrics

Current Price:	$60	**5 Year CAGR Estimate:**	18.3%	**Volatility Percentile:**	83.4%
Fair Value Price:	$98	**5 Year Growth Estimate:**	5.0%	**Momentum Percentile:**	8.5%
% Fair Value:	61%	**5 Year Valuation Multiple Estimate:**	10.3%	**Growth Percentile:**	32.6%
Dividend Yield:	3.0%	**5 Year Price Target**	$125	**Valuation Percentile:**	97.2%
Dividend Risk Score:	D	**Retirement Suitability Score:**	D	**Total Return Percentile:**	93.3%

Overview & Current Events

POSCO – formerly called Pohang Iron & Steel – is the third largest producer of steel and related products in the world. The company – headquartered in Seoul, South Korea – produced about 36 million tons of steel in the most recent fiscal year. Investors can initiate an ownership stake in POSCO through American Depository Receipts that trade on the New York Stock exchange under the ticker PKX with a market capitalization of $19 billion. POSCO reports results in Korean Won, but we'll be using US Dollars throughout the report.

POSCO reported full-year 2018 earnings on 1/30/2019 and results were outstanding. Steel production rose just 1.4%, but higher global steel prices helped drive the highest operating profit total POSCO has produced in the last eight years. The average selling price of carbon steel rose more than 6% on a per-ton basis, helping to drive not only revenue higher, but margins as well. Indeed, revenue was up 7.4% in 2018, adding to significant top line gains accrued in 2017. Gross margins dipped 40bps to 16.1% of revenue, but SG&A costs fell significantly. That helped drive operating profit margin up from 10.2% to 12.4% during the year, capping a banner period for POSCO.

POSCO is also still working on improving its balance sheet via lowering debt and improving its financing ratios. Interest-bearing debt fell about 4% during 2018 after falling 7% in 2017. This has helped drive its current ratio up to 178% in 2018 from 164% in 2017 as steady improvement continues.

An impairment charge drove net profit down on a reported basis, but adjusted, earnings-per-share came in at $9.61 in 2018, a vast improvement over 2017. We see much more muted growth for 2019 as POSCO will be comparing against a very favorable fundamental backdrop from 2018. That should make volume and sales growth tougher to come by, while higher steel prices are already baked into comparable results as well. Our initial estimate for 2019 is $9.80 per share in earnings based upon somewhat cautious guidance from management.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$9.00	$12.00	$10.24	$7.62	$4.13	$1.72	-$0.39	$3.43	$8.01	$9.61	***$9.80***	***$12.50***
DPS	$1.57	$1.96	$2.25	$2.09	$1.77	$1.91	$1.78	$1.75	$2.25	$1.94	***$1.77***	***$2.50***
Shares	307	308	309	309	319	320	320	320	320	320	***320***	***320***

POSCO's earnings-per-share history illustrates the company's dependence on steel prices. The company's adjusted earnings-per-share declined from $12 in fiscal 2010 to a $0.39 deficit in fiscal 2015. Now that prices have risen and the company's performance has normalized, we believe that POSCO's performance will improve moving forward. More specifically, we believe that POSCO is capable of delivering earnings-per-share of around $9.80 in fiscal 2019, with 5% annual growth thereafter. New growth markets such as producing batteries for electric vehicles should help drive some earnings growth over time. In addition, management believes higher pricing will continue in 2019, helping to drive revenue marginally higher despite flat production volumes. Margins will be in focus, but we are optimistic.

From a dividend perspective, POSCO's dividends are declared in Korean Won and are thus subject to foreign exchange fluctuations. We expect the company to pay US$1.77 of dividends in the current fiscal year and generate mid-single digit dividend growth per year over the next half-decade, putting the dividend at $2.50 per share.

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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	9.9	9.2	9.6	10.8	18.1	42.2	N/A	13.8	8.3	7.6	***6.1***	***10.0***
Avg. Yld.	1.8%	1.8%	2.3%	2.5%	2.4%	2.6%	3.7%	3.7%	3.4%	2.7%	***3.0%***	***2.0%***

POSCO's average price-to-earnings ratio over the last decade has been 10.1 if we exclude the years (2013 and 2014) in which the valuation metric was not meaningful high due to depressed earnings. We believe that this valuation multiple is a fair indication of the firm's fair value. For context, POSCO is trading at a price-to-earnings ratio of 6.1 today, which is just 61% of our estimate of fair value. If the company's valuation expands to a price-to-earnings ratio of 10 over the next 5 years, this will add a staggering 10.3% to POSCO's annualized returns. While investors are rightly worried about the balance of supply and demand for steel globally, we believe POSCO is operating well and deserves a much higher price-to-earnings multiple than it is currently trading for. The tremendous results posted in 2018 would suggest the fundamentals for POSCO are much better than the current valuation would suggest.

Income investors should note that the South Korean government applies a 22% withholding tax on dividends paid to international investors. This reduces POSCO's net dividend yield to 2.3%, from a gross dividend yield of 3.0%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

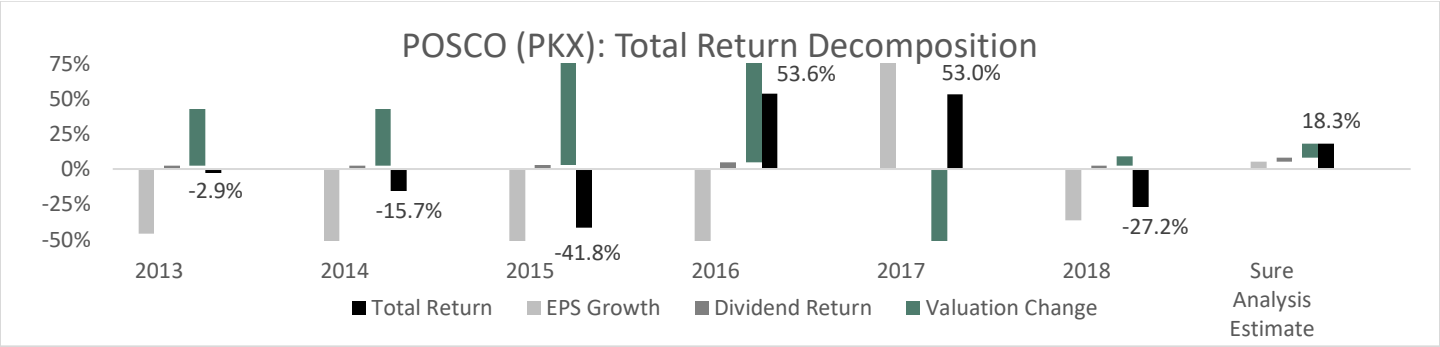
Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	48%	32%	30%	23%	21%	26%	27%	33%	24%	20%	***18%***	***20%***

POSCO'S quality metrics reflect the difficulties of operating in the steel industry. Margins are thin and its stock price standard deviation is far higher than the average in our investment universe. With that said, POSCO has covered its interest expense with its operating income each year during the last decade, and the company's balance sheet is sound with less than half of its total assets financed by debt. Improvements in the past couple of years in the balance sheet have also made its financing situation much more favorable for investors. In addition, it's dividend is just one-fifth of earnings, so the dividend is very safe, even if earnings decline significantly.

Final Thoughts & Recommendation

POSCO appears priced to deliver high double-digits total returns in the coming years. While it certainly is not immune to supply and demand issues in the global market, its earnings and revenue reached records in 2018, indicating that fear at this point is unfounded. Indeed, we believe the stock will return 18.3% annually to shareholders, consisting of the 3.0% yield, 5% earnings growth and a 10.3% tailwind from a higher valuation. Accordingly, POSCO continues to earn a buy recommendation from Sure Dividend at current prices, although we caution that the stock's performance will likely have far more volatility than the average security in our investment universe.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	38393	28986	41265	62171	56101	56280	61437	51682	45561	53246
Gross Profit	8444	4575	7036	8220	6576	6243	6919	5744	5739	7317
Gross Margin	22.0%	15.8%	17.1%	13.2%	11.7%	11.1%	11.3%	11.1%	12.6%	13.7%
SG&A Exp.	1565	1370	1725	2459	2581	2751	3031	2808	2570	2557
D&A Exp.	2188	2008	2616	2044	2271	2447	3072	2842	2766	2917
Operating Profit	6598	3042	4886	5102	3240	2750	2762	2030	2521	4271
Op. Margin	17.2%	10.5%	11.8%	8.2%	5.8%	4.9%	4.5%	3.9%	5.5%	8.0%
Net Profit	4027	2531	3538	3290	2159	1249	600	151	1166	2438
Net Margin	10.5%	8.7%	8.6%	5.3%	3.8%	2.2%	1.0%	0.3%	2.6%	4.6%
Free Cash Flow	-494	1671	-2117	-3800	-162	-2055	-415	4197	2416	2633
Income Tax	1595	422	932	963	863	537	782	235	327	1049

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	36724	42161	60200	67745	73162	80260	78203	68474	66354	74679
Cash & Equivalents	1947	1841	3189	3973	4320	3981	3472	4130	2027	2445
Acc. Receivable	5030	N/A	N/A	8869	9106	9781	9852	7591	7718	8031
Inventories	6773	4318	8686	10613	9770	9603	10179	7265	7879	10103
Goodwill & Int.	566	528	2801	4532	5226	5610	6272	5432	5041	5571
Total Liabilities	14559	15627	27240	32555	34000	36951	36974	30303	28460	30382
Accounts Payable	2855	2830	4461	4188	4540	4766	4503	3301	4227	3976
Long-Term Debt	8540	10259	17611	23165	23002	24829	24987	21387	18800	19716
Total Equity	21633	25902	30917	33140	36416	39741	37858	34942	35053	40866
D/E Ratio	0.39	0.40	0.57	0.70	0.63	0.62	0.66	0.61	0.54	0.48

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	10.8%	6.4%	6.9%	5.1%	3.1%	1.6%	0.8%	0.2%	1.7%	3.5%
Return on Equity	17.1%	10.7%	12.5%	10.3%	6.2%	3.3%	1.5%	0.4%	3.3%	6.4%
ROIC	12.9%	7.5%	8.1%	6.0%	3.6%	1.9%	0.9%	0.2%	2.0%	4.0%
Shares Out.	306	307	308	309	309	319	320	320	320	320
Revenue/Share	127.14	94.53	133.92	201.20	181.57	180.36	192.47	161.52	142.39	166.40
FCF/Share	-1.64	5.45	-6.87	-12.30	-0.53	-6.59	-1.30	13.12	7.55	8.23

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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