POSCO (PKX)

Updated October 27th, 2019 by Josh Arnold

Key Metrics

Current Price:	$45	**5 Year CAGR Estimate:**	8.9%	**Volatility Percentile:**	84.0%
Fair Value Price:	$60	**5 Year Growth Estimate:**	5.0%	**Momentum Percentile:**	11.0%
% Fair Value:	100%	**5 Year Valuation Multiple Estimate:**	0.1%	**Growth Percentile:**	41.0%
Dividend Yield:	4.3%	**5 Year Price Target**	$58	**Valuation Percentile:**	94.2%
Dividend Risk Score:	B	**Retirement Suitability Score:**	B	**Total Return Percentile:**	91.9%

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 $15 billion. POSCO reports results in Korean Won, but we'll be using US Dollars throughout the report.

POSCO reported Q3 earnings on 10/24/19, and results were once again weak as POSCO struggles with global demand for steel products.

Production was roughly flat with last year at 9,554 thousand tons of crude steel, and 9,038 thousand tons of product from the comparable period last year. These were, however, both slight gains against this year's Q2. In terms of sales, volume was down fractionally year-over-year, but up meaningfully from this year's very weak Q2. POSCO said rationalizations, which are headwinds to revenue, largely ended in Q2, driving better volumes. In addition, there were additional production days against Q2.

Lower pricing and higher raw material costs hurt revenue and earnings generation despite the uptick in volumes, and both metrics suffered in Q3. Revenue was off ~2% year-over-year while operating profit plummeted 40%. Operating margins suffered a tremendous decline, falling from 13.8% to 8.6% of revenue year-over-year. POSCO continues to struggle immensely with higher costs and relatively weak volumes.

As a result of the weak Q3, we've cut our earnings-per-share estimate again for 2019 to $6.50.

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	***$6.50***	***$8.30***
DPS	$1.57	$1.96	$2.25	$2.09	$1.77	$1.91	$1.78	$1.75	$2.25	$1.94	***$1.96***	***$2.50***
Shares[1]	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. We continue to see POSCO as having growth potential moving forward after 2019's decline, with 5% annual growth thereafter. New growth markets such as producing batteries for electric vehicles should help drive some earnings growth over time. Margins remain a problem and we see global steel demand as flat for 2019. This combination should lead to a meaningful earnings decline in 2019, but this isn't unusual for POSCO and indeed, other steel companies. Should steel demand fall in 2020 and beyond, POSCO's earnings will be at significant risk. Investors in steel companies must understand that this sector experiences boom and bust cycles in earnings, so growth is non-linear and volatile. Indeed, our earnings estimate revision illustrates just how volatile results can be. However, we feel as though a lot of bad news is priced into our current estimate of $6.50 per share for this year.

[1] Share count in millions

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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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$1.96 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.

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	---	13.8	8.3	7.6	***7.0***	***7.0***
Avg. Yld.	1.8%	1.8%	2.3%	2.5%	2.4%	2.6%	3.7%	3.7%	3.4%	2.7%	***4.3%***	***4.3%***

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 due to depressed earnings. Given the somewhat weak outlook, we have fair value at 7 times earnings, which is a reduction from our previous estimate of 8. This is due to the margin and demand issues discussed above. POSCO is trading at a price-to-earnings ratio of 7.0 today, which is just in line with our estimate of fair value. Thus, we see no impact from the valuation on the total return outlook.

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 3.4%, from a gross dividend yield of 4.3%.

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%	---	33%	24%	20%	***30%***	***30%***

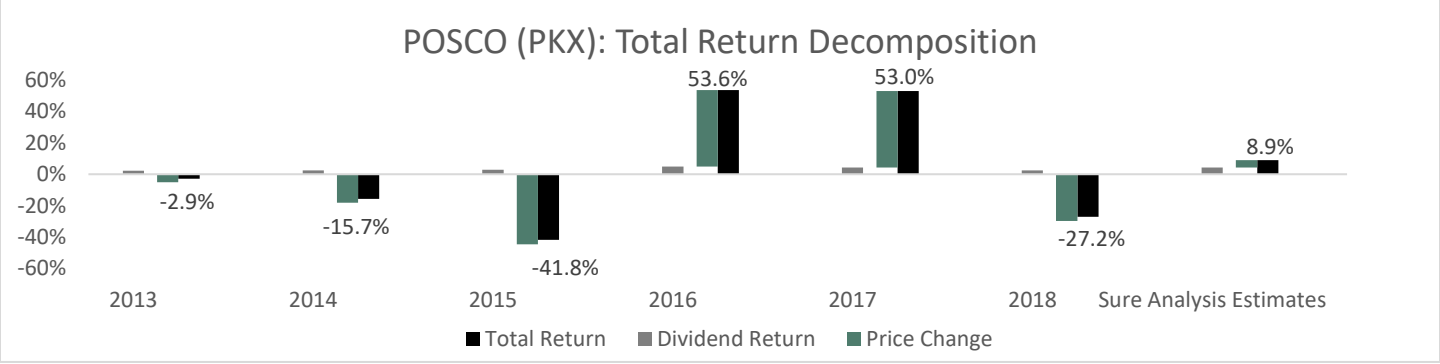
POSCO's dividend should be safe, even in a scenario where earnings decline temporarily. The payout ratio is under one-third of earnings, so we believe investors will continue to receive dividends under most conditions.

Competitive advantages are tough to come by for steel manufacturers, but POSCO has a huge global presence in steel production as one of the largest such companies in the world. This affords it a brand presence and scale that smaller competitors cannot match. Recessions are obviously a huge negative shock to steel producers as demand for all kinds of products declines during downturns. POSCO will suffer material weakness during the next recession.

Final Thoughts & Recommendation

POSCO appears priced to deliver respectable 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, although we expect a material slowdown in 2019. We believe the stock could return 8.9% annually to shareholders, consisting of the robust yield, 5% earnings growth and no impact from the valuation. However, 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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	28986	41265	62171	56101	56280	61437	51682	45561	53246	58952
Gross Profit	4575	7036	8220	6576	6243	6919	5744	5739	7317	7233
Gross Margin	15.8%	17.1%	13.2%	11.7%	11.1%	11.3%	11.1%	12.6%	13.7%	12.3%
SG&A Exp.	1370	1775	2522	2609	2752	3034	2821	2589	2562	1593
D&A Exp.	2008	2616	2044	2271	2447	3072	2842	2766	2917	2965
Operating Profit	3042	4836	5040	3212	2749	2759	2017	2502	4266	5013
Op. Margin	10.5%	11.7%	8.1%	5.7%	4.9%	4.5%	3.9%	5.5%	8.0%	8.5%
Net Profit	2531	3538	3290	2159	1249	600	151	1166	2438	1534
Net Margin	8.7%	8.6%	5.3%	3.8%	2.2%	1.0%	0.3%	2.6%	4.6%	2.6%
Free Cash Flow	1671	-2117	-3800	-162	-2055	-415	4197	2416	2633	2982
Income Tax	422	932	963	863	537	782	235	327	1049	1516

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	42161	60200	67745	73162	80260	78203	68474	66354	74679	69954
Cash & Equivalents	1841	3189	3973	4320	3981	3472	4130	2027	2445	2364
Acc. Receivable	N/A	N/A	8869	9106	9781	9852	7591	7718	8031	8593
Inventories	4318	8686	10613	9770	9603	10179	7265	7879	10103	10281
Goodwill & Int.	528	2801	2901	3267	4353	6188	5304	4907	5379	4451
Total Liabilities	15627	27240	32555	34000	36951	36974	30303	28460	30382	28151
Accounts Payable	2830	4461	4188	4540	4766	4503	3301	4227	3976	4215
Long-Term Debt	10259	17611	23165	23002	24829	24987	21387	18800	19716	18067
Total Equity	25902	30917	33140	36416	39741	37858	34942	35053	40866	38774
D/E Ratio	0.40	0.57	0.70	0.63	0.62	0.66	0.61	0.54	0.48	0.47

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	6.4%	6.9%	5.1%	3.1%	1.6%	0.8%	0.2%	1.7%	3.5%	2.1%
Return on Equity	10.7%	12.5%	10.3%	6.2%	3.3%	1.5%	0.4%	3.3%	6.4%	3.9%
ROIC	7.5%	8.1%	6.0%	3.6%	1.9%	0.9%	0.2%	2.0%	4.0%	2.5%
Shares Out.	307	308	309	309	319	320	320	320	320	320
Revenue/Share	94.53	133.92	201.20	181.57	180.36	192.47	161.52	142.39	166.40	184.22
FCF/Share	5.45	-6.87	-12.30	-0.53	-6.59	-1.30	13.12	7.55	8.23	9.32

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

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