POSCO (PKX)

Updated February 11th, 2020 by Josh Arnold

Key Metrics

Current Price:	$45	**5 Year CAGR Estimate:**	4.8%	**Market Cap:**	$14.9B
Fair Value Price:	$42	**5 Year Growth Estimate:**	2.0%	**Ex-Dividend Date:**	03/27/20[1]
% Fair Value:	108%	**5 Year Valuation Multiple Estimate:**	-1.5%	**Dividend Payment Date:**	06/05/20[2]
Dividend Yield:	4.7%	**5 Year Price Target**	$46	**Years Of Dividend Growth:**	0
Dividend Risk Score:	B	**Retirement Suitability Score:**	B	**Last Dividend Increase:**	N/A

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 $14.9 billion. POSCO reports results in Korean Won, but we'll be using US Dollars throughout the report.

POSCO reported full-year earnings on January 31st and results were mixed, sending shares down on the news, in addition to a less than stellar outlook for 2020. Revenue came in fractionally lower for 2019 over 2018, declining less than 1%. However, lower margins caused operating profit to decline 30% year-over-year as operating margin fell 250bps to just 6% of revenue. Global and Infrastructure profit rose 14%, but that was more than offset by the much larger steel segment, which produced a 41% decline in operating profits. In total, earnings-per-share fell from $5.43 to $4.84 from 2018 to 2019. POSCO did continue its debt reduction, with its net debt declining 16% in 2019 to $6.8 billion.

POSCO offered up modest guidance for 2020, with sales expected to come in at ~$54 billion, slightly lower than 2019. The company expects automobile steel demand to stabilize in 2020, and for shipbuilding steel demand to rebound significantly, driving better margins. However, construction demand is expected to weaken once again, so POSCO is cautious, and so are we. Our initial estimate is for $6 in earnings-per-share for this year.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$12.00	$10.24	$7.62	$4.13	$1.72	-$0.39	$3.43	$8.01	$5.43	$4.84	***$6.00***	***$6.62***
DPS	$1.96	$2.25	$2.09	$1.77	$1.91	$1.78	$1.75	$2.25	$1.94	$1.25	***$2.11***	***$2.22***
Shares[3]	308	309	309	319	320	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 are cautious on global steel demand and as such, have cut our growth estimate from 5% annually to just 1%.

New growth markets such as producing batteries for electric vehicles should help drive some earnings growth over time. However, demand and margins remain a problem we see company guidance for 2020 supporting this view. We see margins improving from very low levels into 2020 on flat revenue, but given POSCO's reliance upon economically sensitive sectors of the economy, risks are high. 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 per share for this year.

[1] Estimated date
[2] Estimated date
[3] 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$2.11 of dividends in the current fiscal year and generate low-single-digit dividend growth per year over the next five years, putting the dividend at $2.22 per share.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	9.2	9.6	10.8	18.1	42.2	---	13.8	8.3	13.6	10.7	***7.6***	***7.0***
Avg. Yld.	1.8%	2.3%	2.5%	2.4%	2.6%	3.7%	3.7%	3.4%	2.7%	2.4%	***4.7%***	***4.8%***

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. This is due to the margin and demand issues discussed above. POSCO is trading at a price-to-earnings ratio of 7.6 today, which is just above our estimate of fair value. Thus, we see a small headwind 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 3.7%, from a gross dividend yield of 4.3%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	32%	30%	23%	21%	26%	---	33%	24%	36%	26%	***35%***	***34%***

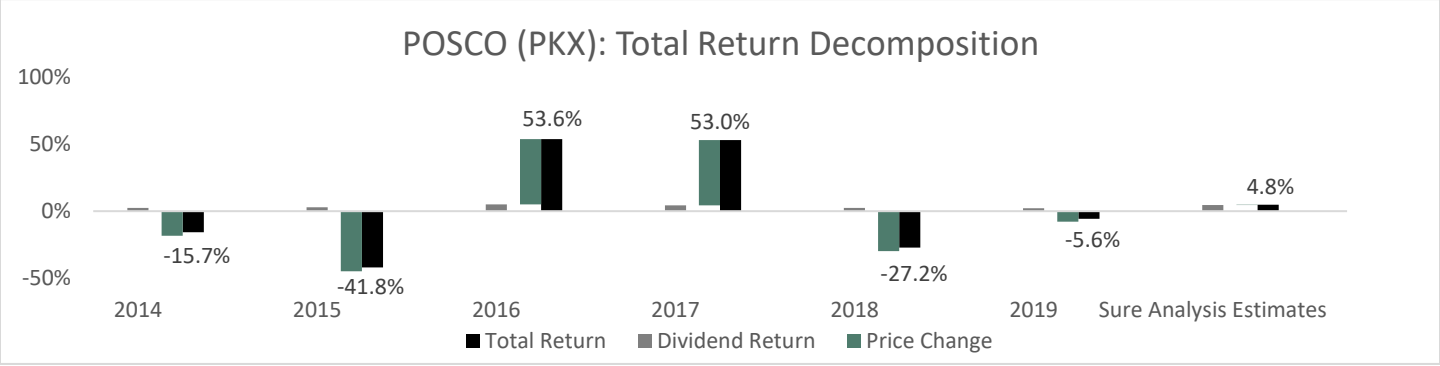
POSCO's dividend should be safe, even in a scenario where earnings decline temporarily. The payout ratio is around one-third of earnings, so we believe investors will continue to receive dividends under most conditions.

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. Results for 2019 weren't particularly good, and while there are some signs of strength, particularly in shipbuilding demand, we are cautious on the steel industry as a whole. We believe the stock could return 4.8% annually to shareholders, consisting of the projected yield, 1% earnings growth and a small headwind from the valuation. We also caution that the stock's performance will likely have far more volatility than the average security in our investment universe, and rate shares a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	41265	62171	56101	56280	61437	51682	45561	53246	58952	59112
Gross Profit	7036	8220	6576	6243	6919	5744	5739	7317	7233	7281
Gross Margin	17.1%	13.2%	11.7%	11.1%	11.3%	11.1%	12.6%	13.7%	12.3%	12.3%
SG&A Exp.	1775	2522	2609	2752	3034	2821	2589	2562	1593	1593
D&A Exp.	2616	2044	2271	2447	3072	2842	2766	2917	2965	2965
Operating Profit	4836	5040	3212	2749	2759	2017	2502	4266	5013	5061
Op. Margin	11.7%	8.1%	5.7%	4.9%	4.5%	3.9%	5.5%	8.0%	8.5%	8.6%
Net Profit	3538	3290	2159	1249	600	151	1166	2438	1534	1553
Net Margin	8.6%	5.3%	3.8%	2.2%	1.0%	0.3%	2.6%	4.6%	2.6%	2.6%
Free Cash Flow	-2117	-3800	-162	-2055	-415	4197	2416	2633	2982	2982
Income Tax	932	963	863	537	782	235	327	1049	1516	1527

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	60200	67745	73162	80260	78203	68474	66354	74679	69954	70427
Cash & Equivalents	3189	3973	4320	3981	3472	4130	2027	2445	2364	2364
Acc. Receivable	N/A	8869	9106	9781	9852	7591	7718	8031	8593	7732
Inventories	8686	10613	9770	9603	10179	7265	7879	10103	10281	10865
Goodwill & Int.	2801	2901	3267	4353	6188	5304	4907	5379	4451	4451
Total Liabilities	27240	32555	34000	36951	36974	30303	28460	30382	28151	28701
Accounts Payable	4461	4188	4540	4766	4503	3301	4227	3976	4215	4282
Long-Term Debt	17611	23165	23002	24829	24987	21387	18800	19716	18067	18067
Total Equity	30917	33140	36416	39741	37858	34942	35053	40866	38774	38732
D/E Ratio	0.57	0.70	0.63	0.62	0.66	0.61	0.54	0.48	0.47	0.47

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	6.9%	5.1%	3.1%	1.6%	0.8%	0.2%	1.7%	3.5%	2.1%	2.1%
Return on Equity	12.5%	10.3%	6.2%	3.3%	1.5%	0.4%	3.3%	6.4%	3.9%	3.9%
ROIC	8.1%	6.0%	3.6%	1.9%	0.9%	0.2%	2.0%	4.0%	2.5%	2.5%
Shares Out.	308	309	309	319	320	320	320	320	320	320
Revenue/Share	133.92	201.20	181.57	180.36	192.47	161.52	142.39	166.40	184.22	184.72
FCF/Share	-6.87	-12.30	-0.53	-6.59	-1.30	13.12	7.55	8.23	9.32	9.32

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

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