# POSCO (PKX)

*Updated July 29th, 2020 by Nikolaos Sismanis*

## Key Metrics

| | | | | | |
|---|---|---|---|---|---|
| **Current Price:** | $41.5 | **5 Year CAGR Estimate:** | 2.5% | **Market Cap:** | $13.1B |
| **Fair Value Price:** | $35 | **5 Year Growth Estimate:** | 2.0% | **Ex-Dividend Date:** | 03/27/20 |
| **% Fair Value:** | 119% | **5 Year Valuation Multiple Estimate:** | -3.3% | **Dividend Payment Date:** | 06/05/20 |
| **Dividend Yield:** | 3.9% | **5 Year Price Target** | $39 | **Years Of Dividend Growth:** | 0 |
| **Dividend Risk Score:** | C | **Retirement Suitability Score:** | C | **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 $13 billion. POSCO reports results in Korean Won, but we'll be using U.S. Dollars throughout the report.

POSCO reported its Q2 earnings on July 21st, with results coming in weak, as expected. Revenues declined by -21.6% year-over-year as production volumes fell -18%, and sales volume declined by -8.3%. The company's experienced weaker demand due to COVID-19. However, management was able to minimize the impact of reduced production by adopting a flexible sales system.

We expect the company's second half to see increased production, as the steel demand gradually resumes around the world. However, we retain our FY2020 EPS estimates at $3.75, considering that the company barely broke even during the quarter.

Despite the setbacks, POSCO thoughtfully managed its cash flows by increasing its cash position by 71% year-over-year, while still slightly reducing its debt on a quarter-over-quarter basis.

## 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 | ***$3.75*** | ***$5.52*** |
| **DPS** | $1.96 | $2.25 | $2.09 | $1.77 | $1.91 | $1.78 | $1.75 | $2.25 | $1.94 | $1.25 | ***$1.65*** | ***$1.65*** |
| **Shares**[1] | 308 | 309 | 309 | 319 | 320 | 320 | 320 | 320 | 320 | 320 | ***318*** | ***318*** |

POSCO's earnings-per-share history demonstrates 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 about global steel demand, especially in a potential scenario where COVID-19 reignites globally. As a result, we have a low forecast growth rate of just 2%. Management sees new growth opportunities ahead, such as environment-friendly vehicles & energy, mega-city industries, which could help drive some earnings growth over time. However, the current demand and margins remain a problem. The company reported an operating profit margin of just 1.2%, which builds little excitement in terms of a more profitable future. We expect the company's margins to expand as global demand resumes. However, profitability risks remain, as commodity prices are highly unpredictable and are expected to fluctuate significantly in times of uncertainty, similar to the current situation.

Further, we retain our medium-term 5-year DPS outlook to be around $1.65, in line with the company's long-term payout ratio target of around 30%. Considering the company's highly fluctuating financials, such a low payout ratio makes for a prudent policy. It's also typical amongst companies in the steel sector, as they reserve liquidity for times of adversity.

[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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## 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 | ***8.3*** | ***7.0*** |
| **Avg. Yld.** | 1.8% | 2.3% | 2.5% | 2.4% | 2.6% | 3.7% | 3.7% | 3.4% | 2.7% | 2.4% | ***3.9%*** | ***4.3%*** |

We are using an earnings power estimate of $5 per share for our fair value and valuation calculations, instead of actual earnings estimates for 2020. POSCO's average price-to-earnings ratio over the past decade has been around 10 (excluding the years 2014 and 2015) in which the valuation metric was not meaningful due to depressed earnings. Given the uncertainty surrounding the foreseeable future, we have assigned a fair value at 7 times earnings in the medium-term. Our multiple contraction is to reflect the margin and demand issues discussed earlier, as well as the fluctuations of the commodity's price. POSCO is trading at a price-to-earnings power ratio of 8.3 today, higher than our previous report, as shares have advanced higher. The dividend yield also moderately decreased for that reason as well. Considering our lower medium-term P/E estimates, 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 3.04%, from a gross dividend yield of 3.9%.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

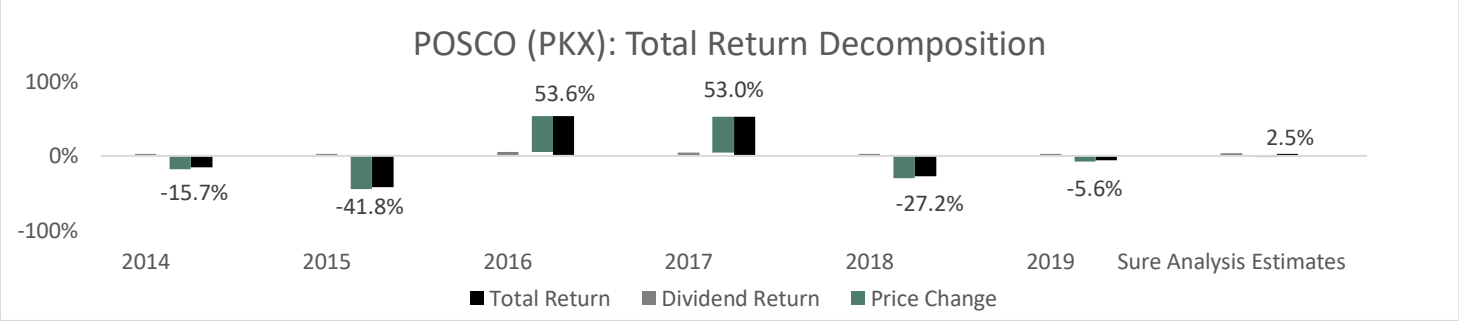
| Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Payout** | 32% | 30% | 23% | 21% | 26% | --- | 33% | 24% | 36% | 26% | ***33%*** | ***30%*** |

POSCO's dividend should be safe, even in a scenario where earnings decline temporarily further. The payout ratio is around one-third of earnings, so we believe investors will continue to receive dividends under most conditions. The company has thus far made no mention of cutting or suspending the dividend. 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. Therefore, POSCO will suffer considerably during this recession.

## Final Thoughts & Recommendation

POSCO appears priced to deliver marginal returns in the coming years. Results for 2020 have been weak so far, and while there are some signs of strength, particularly in shipbuilding demand, we are cautious on the steel industry as a whole given COVID-19. We believe the stock could return 2.5% annually to shareholders, consisting of the projected yield, 2% earnings growth, and a small headwind from the valuation. Considering the uncertainties of the sector, as well as the stock being overvalued in terms of our estimated fair value, we rate POSCO 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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