

**Nat Resources & Energy**  
**Metals & Mining**  
 Equity – Korea

## Overweight (V)

Target price (KRW)	650000.00
Share price (KRW)	541000.00
Potential total return (%)	22.3

Performance	1M	3M	12M
Absolute (%)	-1.1	-6.6	68.8
Relative <sup>A</sup> (%)	-1.5	-6.4	10.2

Index<sup>A</sup> KOSPI INDEX

RIC 005490.KS  
 Bloomberg 005490 KS

Market cap (USDm) 35,812  
 Market cap (KRWb) 40,937

Enterprise value (KRWb) 30014  
 Free float (%) 73

Note: (V) = volatile (please see disclosure appendix)

**4 March 2010**

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# POSCO (005490.KS)

OW(V): Looking downstream at Daewoo International

- **Aggressive investment drive continues with formal bid for controlling stake of Daewoo International (Daewoo)**
- **Strategically logical as Daewoo would provide POSCO with downstream integration; if successful, we estimate the deal should be mildly accretive**
- **Reiterate OW(V) rating, target price KRW650,000**

**Leading the race for Daewoo International (Daewoo, 047050.KS, N/R).** Earlier this week, POSCO made a formal bid to purchase a 68.8% controlling stake in Daewoo, a Korean trading and energy development company. Amongst four formal bidders, we believe POSCO is the leading contender as in contrast to the other bidders, POSCO has considerable financial strength with an under geared balance sheet and the ability to extract operational synergies with Daewoo. The two companies also already have JV relationships in Mexico and Indonesia.

**Strategically logical, mildly accretive.** We regard the potential transaction as strategically logical given the vertical integration gained through extending control of its steel distribution network. Of POSCO's 2009 export sales, 38% was distributed under the company's internal marketing divisions. Daewoo accounted for 20% of export volume, representing the largest of POSCO's third party vendors. Financially, we calculate that the deal may be mildly accretive (around +2%) to POSCO's earnings over the next two years, with its balance sheet moving to a small net debt position (4.2% ND/ND+E 2011E) from its current net cash position. Over the past decade, the company has focused on upstream investments (iron ore and coking coal) but the move for Daewoo marks an opportunistic move to downstream assets, in our view.

**Reiterate OW(V) rating, KRW650000 target implies 22% total return.** We maintain an OW(V) rating, keeping a target of KRW650,000 based on 1.4x PB, in line with the sector average. Near term catalysts remain the outcome of iron ore/coal negotiations along with steel price movements. In our view, tight regional markets should see POSCO hike export prices in the near term, while domestic contract pricing should also likely be raised following settlement of annual contracts for raw materials.

## POSCO – Key data

YE Dec	Sales (KRWbn)	NPAT (KRWbn)	EPS (KRW)	PE (x)	P/B (x)	Div Yield (%)	ND/E (%)	EV/EBITDA (x)
FY09	26,954	3,172	41,426	13.1	1.3	1.5%	-1%	5.8
FY10e	30,665	4,546	59,370	9.1	1.2	2.2%	-2%	3.7
FY11e	32,475	4,461	58,266	9.3	1.1	2.2%	-4%	3.6
FY12e	33,168	4,547	59,390	9.1	1.0	2.2%	-8%	3.4

Note: Ratios based on closing price as on 4 March 2010.  
 Source: Company, HSBC estimates.

## Financials & valuation

### Financial statements

Year to	12/2009a	12/2010e	12/2011e	12/2012e
<b>Profit &amp; loss summary (KRWb)</b>				
Revenue	26,954	30,665	32,475	33,168
EBITDA	5,311	8,338	8,185	8,241
Depreciation & amortisation	-2,163	-2,466	-2,466	-2,466
Operating profit/EBIT	3,148	5,872	5,719	5,776
Net interest	-27	60	51	58
PBT	3,583	5,682	5,870	5,984
HSBC PBT	3,583	5,682	5,870	5,984
Taxation	-411	-1,136	-1,409	-1,436
Net profit	3,172	4,546	4,461	4,547
HSBC net profit	3,172	4,546	4,461	4,547

### Cash flow summary (KRWb)

Cash flow from operations	6,579	7,048	6,767	6,891
Capex	-5,017	-6,164	-4,890	-4,468
Cash flow from investment	-6,617	-6,164	-4,890	-4,468
Dividends	-574	-613	-892	-909
Change in net debt	-1,865	-271	-985	-1,513
FCF equity	7,535	-2,372	1,741	2,395

### Balance sheet summary (KRWb)

Intangible fixed assets	160	160	160	160
Tangible fixed assets	16,702	20,401	22,824	24,827
Current assets	12,918	13,947	15,994	18,386
Cash & others	6,754	7,749	9,580	11,824
Total assets	39,993	44,721	49,191	53,585
Operating liabilities	2,314	2,384	2,441	2,465
Gross debt	6,315	7,039	7,884	8,616
Net debt	-439	-710	-1,695	-3,208
Shareholders funds	30,951	34,884	38,454	42,092
Invested capital	20,712	24,375	26,958	29,083

### Ratio, growth and per share analysis

Year to	12/2009a	12/2010e	12/2011e	12/2012e
<b>Y-o-y % change</b>				
Revenue	-12.0	13.8	5.9	2.1
EBITDA	-37.1	57.0	-1.8	0.7
Operating profit	-51.9	86.5	-2.6	1.0
PBT	-38.5	58.6	3.3	1.9
HSBC EPS	-29.7	43.3	-1.9	1.9

### Ratios (%)

Revenue/IC (x)	1.3	1.4	1.3	1.2
ROIC	13.4	20.8	16.9	15.7
ROE	10.8	13.8	12.2	11.3
ROA	8.7	11.0	9.8	9.1
EBITDA margin	19.7	27.2	25.2	24.8
Operating profit margin	11.7	19.1	17.6	17.4
EBITDA/net interest (x)	199.4			
Net debt/equity	-1.4	-2.0	-4.4	-7.6
Net debt/EBITDA (x)	-0.1	-0.1	-0.2	-0.4
CF from operations/net debt				

### Per share data (KRW)

EPS reported (fully diluted)	41426.19	59369.90	58266.39	59390.00
HSBC EPS (fully diluted)	41426.19	59369.90	58266.39	59390.00
DPS	8000.00	11873.98	11653.28	11878.00
NAV	404218.81	455588.70	502201.81	549713.81

### Key forecast drivers

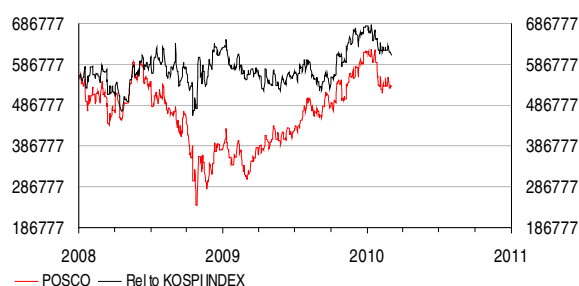
Year to	12/2009a	12/2010e	12/2011e	12/2012e
Crude steel production (Mt)	29.5	34.4	34.4	34.4
HRC steel prices (USD/t)	511	574	630	646
CRC steel prices (USD/t)	603	661	716	733
Iron Ore (USD/t)	86	88	93	86
Coking coal (USD/t)	172	167	180	165
Exchange Rate (KRW/USD)	1,276	1,113	1,050	1,103

### Valuation data

Year to	12/2009a	12/2010e	12/2011e	12/2012e
EV/sales	1.1	1.0	0.9	0.8
EV/EBITDA	5.7	3.6	3.5	3.3
EV/IC	1.5	1.2	1.1	0.9
PE*	13.1	9.1	9.3	9.1
P/NAV	1.3	1.2	1.1	1.0
FCF yield (%)	24.5	-7.7	5.7	7.8
Dividend yield (%)	1.5	2.2	2.2	2.2

Note: \* = Based on HSBC EPS (fully diluted)

### Price relative



Source: HSBC

Note: price at close of 04 Mar 2010

## Daewoo International stake may be c2% EPS accretive for POSCO

We view POSCO's potential controlling stake in Daewoo International as strategically logical, allowing the company to further diversify its asset portfolio and obtain potential vertical integration synergies. Bloomberg reported on 23 Feb that Chung Joon Yang (POSCO CEO) confirmed that Daewoo International was considered a 'top acquisition priority' for the company. Daewoo International acts as a primary export facilitator of POSCO's steel products, handling the largest share (c20%) of POSCO's export volumes assigned to domestic traders. In addition, management believe that Daewoo's energy development business will assist the company in raw materials procurement and act as a natural hedge to raw material costs. The two companies already have existing relationships through service centres in Indonesia and Mexico.

Given press reports (Bloomberg and Asiapulse) have speculated the deal to be in the region of KRW2.2trn to KRW2.6trn taking into consideration the market value of a 68.8% stake in Daewoo International, we assume a median acquisition price of KRW2.4trn. We assume POSCO is able to achieve operational synergies of around 2% of revenues through vertical integration of its steel marketing division. Based on our calculations we believe acquiring Daewoo would be c2% earnings accretive for POSCO in the next two years. If operational synergies were assumed to be 3% of revenues, earnings accretion would increase to 3.6% in 2011e. In terms of balance sheet impact, at the price mentioned, the acquisition of Daewoo International would move POSCO to a marginal net debt position from 2011e to 4.2% (ND/ND+E) from -4.6% net cash.

### Daewoo International stake acquisition: Forecast P&L sensitivity analysis

		2011e	2012e
Revenue - POSCO	(KRWm)	32,475,092	33,168,310
Revenue - Daewoo International	(KRWm)	12,566,973	14,712,738
<b>Revenue - Proforma</b>	<b>(KRWm)</b>	<b>41,121,169</b>	<b>43,290,674</b>
EBITDA - POSCO	(KRWm)	8,184,598	8,241,203
EBITDA - Daewoo International	(KRWm)	258,011	306,111
Cost savings (2% of Revenue)	(KRWm)	172,922	202,447
<b>EBITDA - Proforma</b>	<b>(KRWm)</b>	<b>8,535,031</b>	<b>8,654,254</b>
Net Profit - POSCO	(KRWm)	4,461,453	4,547,487
Net Profit - Daewoo International	(KRWm)	160,723	171,951
<b>Net Profit - Proforma</b>	<b>(KRWm)</b>	<b>4,554,648</b>	<b>4,658,121</b>
EPS - POSCO	(KRW)	58,266	59,390
EPS - Daewoo International	(KRW)	1,596	1,740
<b>EPS - Proforma</b>	<b>(KRW)</b>	<b>59,484</b>	<b>60,835</b>
EBITDA Accretion	(%)	4.3%	5.0%
EPS Accretion	(%)	2.1%	2.4%

Note: Daewoo International figures are on a 100% basis while Proforma figures assume POSCO acquires a 68.8% stake in Daewoo International. Using closing prices as at 4 March 2010.  
Source: Bloomberg consensus data for Daewoo, Company reports, HSBC estimates.

### Daewoo International stake acquisition: Balance Sheet impact

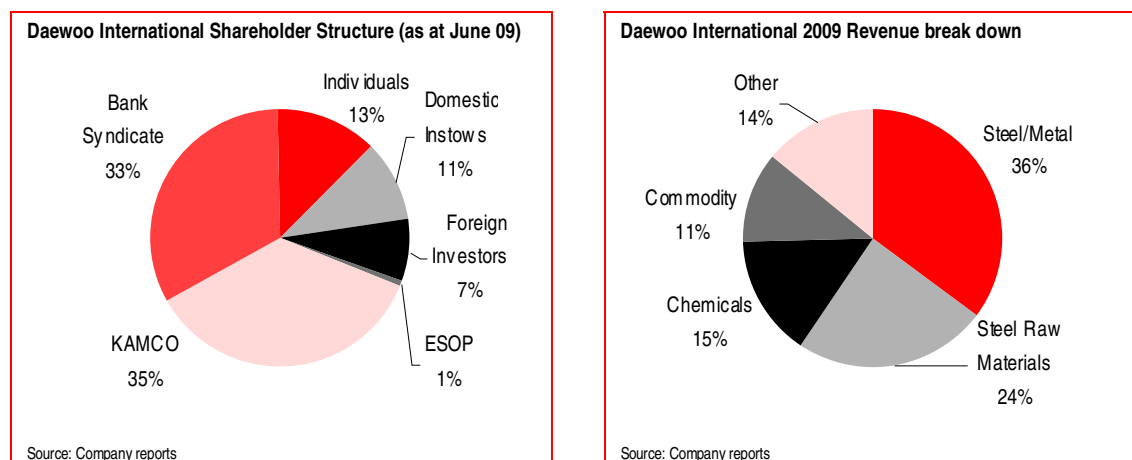
		2011e
Net debt/(cash) - POSCO	(KRWm)	(1,695,324)
Gearing (ND/ND+E) - POSCO	(%)	-4.6%
Net debt/(cash) - Daewoo Intl	(KRWm)	840,656
<b>Net debt/(cash) - Proforma</b>	<b>(KRWm)</b>	<b>1,578,904</b>
<b>Gearing (ND/ND+E) - Proforma</b>	<b>(%)</b>	<b>4.2%</b>

Note: Daewoo International figures are on a 100% basis while Proforma figures assume POSCO takes on acquisition debt of KRW3trn.  
Source: Bloomberg, Company reports, HSBC estimates.

## POSCO bids for Daewoo International

### Spotlight on Daewoo International

Daewoo International is a Korean trading company with primary operations in commodity trading and energy development, with steel-related trading activities accounting for more than 60% of Daewoo International's 2008 sales revenue. The company noted in its 1H09 results presentation that a combined 68.8% controlling stake in Daewoo International (currently owned by Korea Asset Management Corp and a syndicate of 8 Korean domestic banks) is up for sale.



### POSCO emerge as the lead contender in bidding war

Over the past 6 months, there has been persistent media speculation in Reuters, Bloomberg and the local Korean press on potential bidders for Daewoo International, with names ranging from POSCO to SK Energy and Hanwha Group. With the letter of intent deadline passing on 24 Feb 2010, four solid bidders for Daewoo International have emerged. We have provided a table below with details on the known bidders. Given POSCO's considerable financial capabilities and potential operational synergy, we believe it is the obvious leading contender to win the controlling stake in Daewoo International. Local media reports suggest that the bidding process will conclude in May/June 2010 with transaction completion in 2H10e.

#### Profile of Daewoo International Bidders

Daewoo Intl Bidders	Primary Motive for Bid	Additional comments
POSCO	Vertical integration synergies through trading supply chain	- c20% of POSCO's steel export volumes are handled by Daewoo International - Existing JV relationships in Vietnam and Mexico
Lotte Group	Diversifying asset portfolio to include overseas energy/resources business	- Assistance in raw materials procurement through Daewoo Intl's energy development business - Lotte is an existing conglomerate with businesses such as retail, chemicals and financial services. - Potential synergies through trading business and Daewoo Intl's 24% stake in Kyobo Life Insurance
Daewoo Partners Consortium	Investment purposes	A private equity fund consisting of former Daewoo Group executives
Unknown PE fund	Investment purposes	Unidentified foreign private equity fund

Source: Bloomberg, Reuters, The Korea Times and Company reports, HEBC estimates

## Opportunistic M&A growth strategy with focus widening to downstream assets

At the company's 4Q09 results in mid Jan 10, management highlighted that its plans to double its investment spending to KRW9.3trn in 2010 with a view to participate in domestic M&A opportunities and upstream acquisitions in iron ore and coking coal assets. As detailed in the table below, POSCO has been a relatively active participant in M&A transactions albeit with a focus on upstream assets. An opportunistic move for Daewoo International is representative of management widening its acquisition focus to include downstream assets.

### POSCO's Major M&A Transaction History since 2009

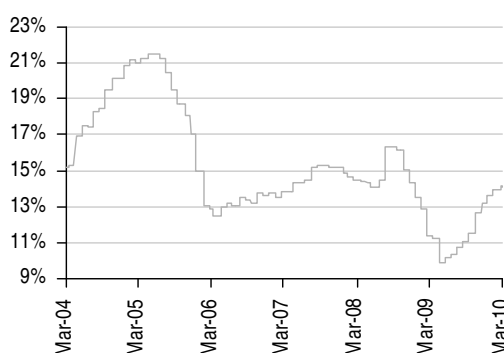
Announcement Date	Company	Country	Investment Value	Status	Upstream/Downstream/Diversified	Transaction Description
1-Jul-09	Dongbu Metal	Korea	KRW220bn	Active	Upstream	JV agreement to construct 75kt high manganese steel from April 2010
8-Jul-09	Macarthur Coal	Australia	USD404m	Active	Upstream	Took 10% stake in Macarthur Coal (PCI Coal Producer)
11-Sep-09	Cockatoo Coal	Australia	c. AUD5m	Active	Upstream	Purchase of 15m additional shares
23-Sep-09	Jupiter Mines	Australia	USD6.8m	Active	Upstream	Approved for 13% ownership stake
25-Sep-09	POSCO E & C	Korea	cUSD912m	Pending	Downstream	Speculated IPO of POSCO's E & C Division
29-Sep-09	Asia Stainless	Vietnam	N/A	Active	Upstream	Completion of 90% stake acquisition
30-Sep-09	UKTMP	Kazakhstan	USD50m	Pending	Upstream	Signed MOA to set up a titanium slab plant with 50% stake
20-Oct-09	POSCO	Vietnam	USD528M	Active	Upstream	Open a new 1.2mt CR steel mill in Ho Chi Minh City
8-Oct-09	Thainox	Thailand	cTHB23bn	Pending	Upstream	Media speculated 85% stake
2-Nov-09	Krakatau Steel	Indonesia	USD3.75bn	Pending	Upstream	Signed MOA to construct integrated steel mill with 6mt
27-Nov-09	POSCO	Korea	N/A	Pending	Upstream	Signed MOU to build magnesium refinery plant of 10kt capacity in Gangwon
14-Jan-10	Roy Hill	Australia	USD360m	Active	Upstream	Acquisition of 15% stake in Roy Hill iron ore

Source: Reuters, Bloomberg, Company reports, HSBC.

## Valuation and risks

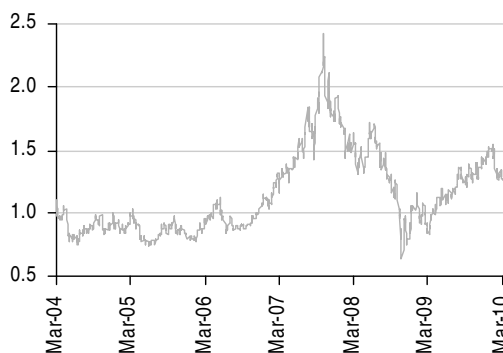
We maintain our OW(V) rating and keep our target price at KRW650,000, valuing the stock at 1.4x PB broadly in line with the sector average and 2010e book value of KRW455,589 per share. We arrive at a PB multiple of 1.4x from our residual income model ( $P/B = ROE - g / COE - g$ ) using a sustainable ROE of 17%, slightly ahead of POSCO's historical average (16%). We consider POSCO stock to be volatile. Under our research model, for Korean stocks with a volatility indicator, the Neutral band is 10 percentage points around the hurdle rate of 10.5%. Our KRW650,000 target price implies a potential return of 20.1% over the closing price on 4 March of KRW541,000. Adding in the 2010e 2.2% dividend yield implies a potential total return of 22.3%, which is above the Neutral (V) band. The upside and downside risks for POSCO lie in the movement of steel prices. The key downside risks are a more severe slowdown in the US or China, which in turn would negatively impact steel consumption growth. Movements in raw material prices provide additional risk.

POSCO 1 year forward ROE



Source: HSBC, Thomson Reuters Datastream.

POSCO 1 year forward PBV



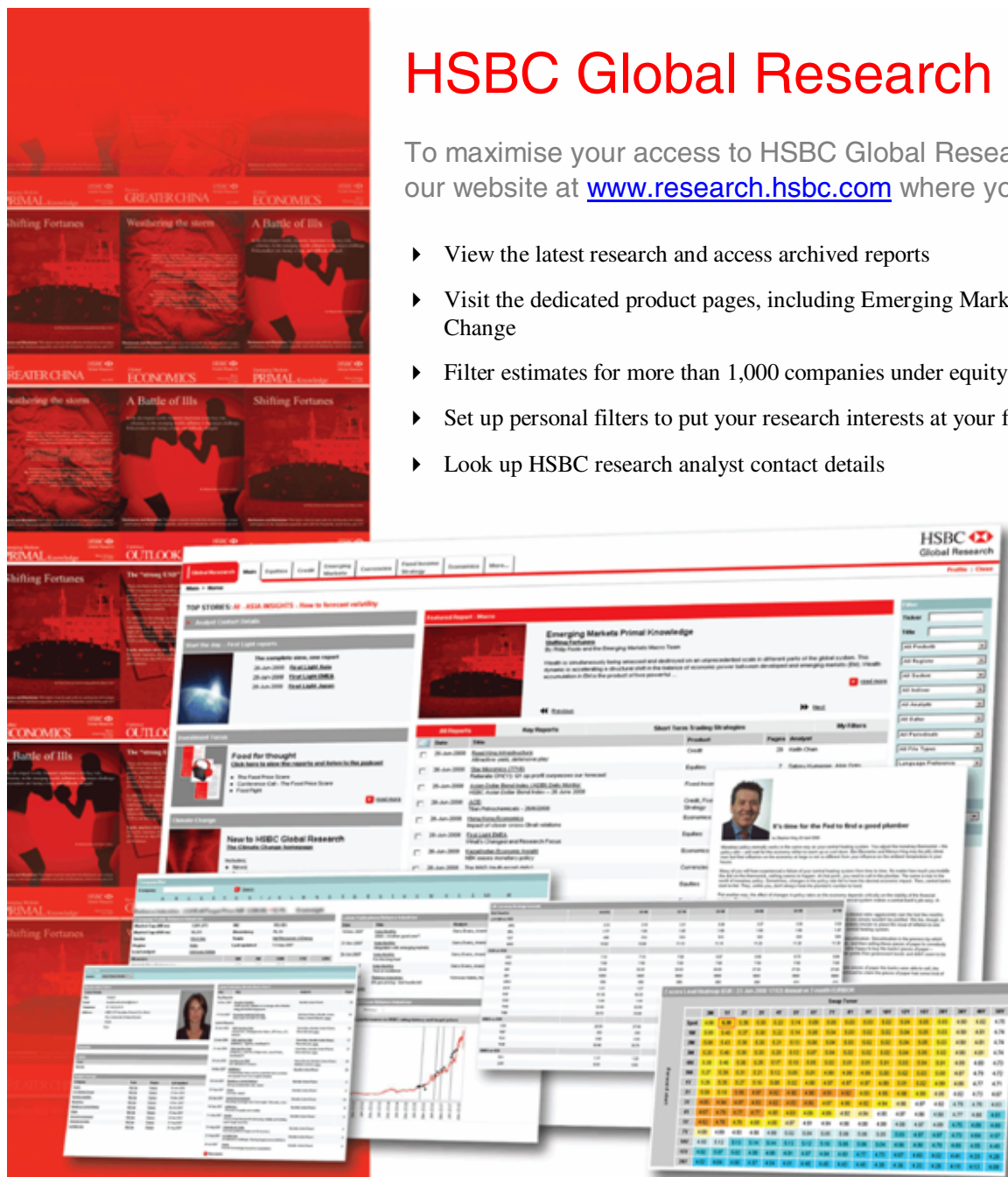
Source: HSBC, Thomson Reuters Datastream.



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# Disclosure appendix

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## Important disclosures

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HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 12 month time horizon; and 2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0-3 month time horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at [www.hsbcnet.com/research](http://www.hsbcnet.com/research). Details of these short-term investment opportunities can be found under the Reports section of this website.

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### Stock ratings

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However,

stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

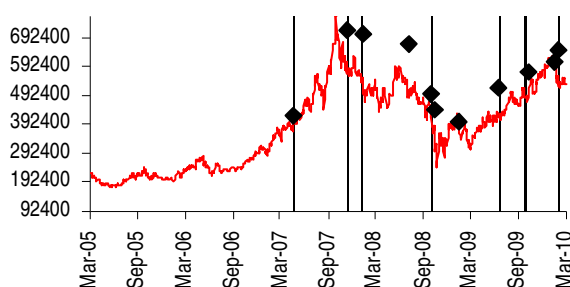
## Rating distribution for long-term investment opportunities

**As of 04 March 2010, the distribution of all ratings published is as follows:**

<b>Overweight (Buy)</b>	47%	(12% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	37%	(11% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	16%	(11% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities

POSCO (005490.KS) Share Price performance KRW Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Neutral (V)	25 April 2007
Neutral (V)	Overweight	13 November 2007
Overweight	Overweight (V)	11 January 2008
Overweight (V)	Neutral (V)	29 September 2008
Neutral (V)	Overweight (V)	19 June 2009
Overweight (V)	Neutral (V)	25 September 2009
Neutral (V)	Overweight (V)	04 February 2010
Target Price	Value	Date
Price 1	420000.00	25 April 2007
Price 2	715000.00	13 November 2007
Price 3	700000.00	11 January 2008
Price 4	670000.00	11 July 2008
Price 5	500000.00	29 September 2008
Price 6	440000.00	14 October 2008
Price 7	400000.00	15 January 2009
Price 8	515000.00	19 June 2009
Price 9	575000.00	14 October 2009
Price 10	605000.00	14 January 2010
Price 11	650000.00	04 February 2010

Source: HSBC



## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
POSCO	005490.KS	532000.00	03-Mar-2010	7, 11

Source: HSBC

- 1 HSBC\* has managed or co-managed a public offering of securities for this company within the past 12 months.
- 2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
- 3 At the time of publication of this report, HSBC Securities (USA) Inc. is a Market Maker in securities issued by this company.
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- 5 As of 31 January 2010, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of investment banking services.
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- 7 As of 31 January 2010, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-securities services.
- 8 A covering analyst/s has received compensation from this company in the past 12 months.
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