

## POSCO

Formed in 1968 with the goal of rebuilding South Korea's steel industry, Posco is now the third largest steel maker in the world, and it helps meet the steel demand of more than 20 countries across the globe. Asia features many of the world's fastest growing economies and Posco's proximity to this growth, combined with its reputation for quality and innovation, should provide strong business opportunities. In addition, a variety of initiatives related to control over distribution channels, raw material inputs and cost-saving technologies provide continued opportunities to profitably meet global steel demand.

While selling steel to some of the fastest growing economies is interesting to us, we wouldn't be interested from an investment standpoint without a clear competitive advantage. And given that steel is typically viewed as a commodity, even a good steel maker might rate a pass without a compelling reason to believe competitors would have a hard time overtaking it. But Posco has real technological advantages that translate into lower production costs and higher margins. One source of these advantages is a production process employing proprietary FINEX technology. FINEX reduces costs by 1) using lower priced raw materials that don't require any preprocessing, 2) allowing for lower production temperatures and therefore less energy use, and 3) requiring a smaller production facility—making FINEX plants cheaper to build on an output basis. Developed about a decade ago in partnership with German industrial conglomerate Siemens, FINEX helped boost Posco's net profit margins from a 7-10% range to a 12-15% range since it opened the first FINEX plant in 2004. Today, the company continues to pursue several technological initiatives designed to reduce costs without compromising the quality of steel. It's not clear that any current projects will yield the same dramatic results as FINEX, but it's easy to see why some investors consider Posco a technology company as much as a steel company.

South Korea's economic emergence has certainly helped Posco; it enjoyed significant growth and profitability as South Korea advanced from the 29<sup>th</sup> largest economy in the world in 1960 to the 15<sup>th</sup> largest last year. More recently, the success of Korean auto makers Kia and Hyundai has fueled domestic demand for steel. And today, Posco benefits from demand created by the emergence of countries like China and Vietnam, where a boom in both infrastructure construction and export production strains the ability of those nations to produce enough steel to meet demand. In fact, Posco provides close to 20% of China's steel imports. It's also worth noting that Posco's ability to produce very high-quality steel products for a range of applications should continue to generate opportunities, even as emerging market production ramps up. Posco also does well with more established economies in the region, as evidenced by its position as the top foreign steel supplier to Japan. The company has set its sights on expanding

production beyond Asia, with a new FINEX plant opening in Mexico this summer and plans to build another in India in the near future. And recent joint ventures with companies like U.S. Steel will likely lead to greater sales in developed countries.

In addition to Posco's revenue growth opportunities, other initiatives include plans to acquire raw material producers and steel distributors in order to maintain better control over inputs and customer relationships. If successful, the company could retain more of the profits by performing these functions itself.

Examining a company's balance sheet is always an important task for us. Even companies with obvious competitive advantages can succumb to the risks of excessive leverage, especially capital-intensive businesses such as steel producers. For Posco, the primary source of funds is cash from operations. Management maintains an intense focus on drawing as much cash as possible from day-to-day operations, thereby reducing the need for external funding. The result is a company capable of producing more than 32 million tons of steel with just 17% of its assets financed with long-term debt. That's a low level of financial risk for a large-scale production company. Relying less on external sources of capital gives Posco a greater margin of safety when riding out the troughs of global steel demand. Put differently, Posco would be a very different company today if it were forced to refinance a large amount of debt in the current illiquid credit environment.

Investing in a company outside the U.S. typically adds a level of risk and uncertainty. In this case, the South Korean government views Posco as a critical partner in the success of the nation as a whole. As a result, we would expect the government to have significant influence in matters of strategic decision making. Also, South Korean businesses tend to be part of somewhat loose conglomerates called "chaebols." Basically, this means that management teams from different businesses such as banking or auto making informally agree to do business with one another and protect each other against competitors. For shareholders, this adds some stability to the business but also results in a highly entrenched management team. That said, we do admire the track record of growth and innovation, strategic decision making and conservatism demonstrated by Posco's senior managers, and we view South Korea as a relatively stable nation.

All in all, Posco is an attractive business. It's a company with a clear history of innovation and superior operating performance, which have allowed it to establish durable competitive advantages. Combined with a solid management team and a powerful presence in some of the most attractive markets on the globe, we're optimistic Posco will continue to remain a successful and highly profitable business.

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