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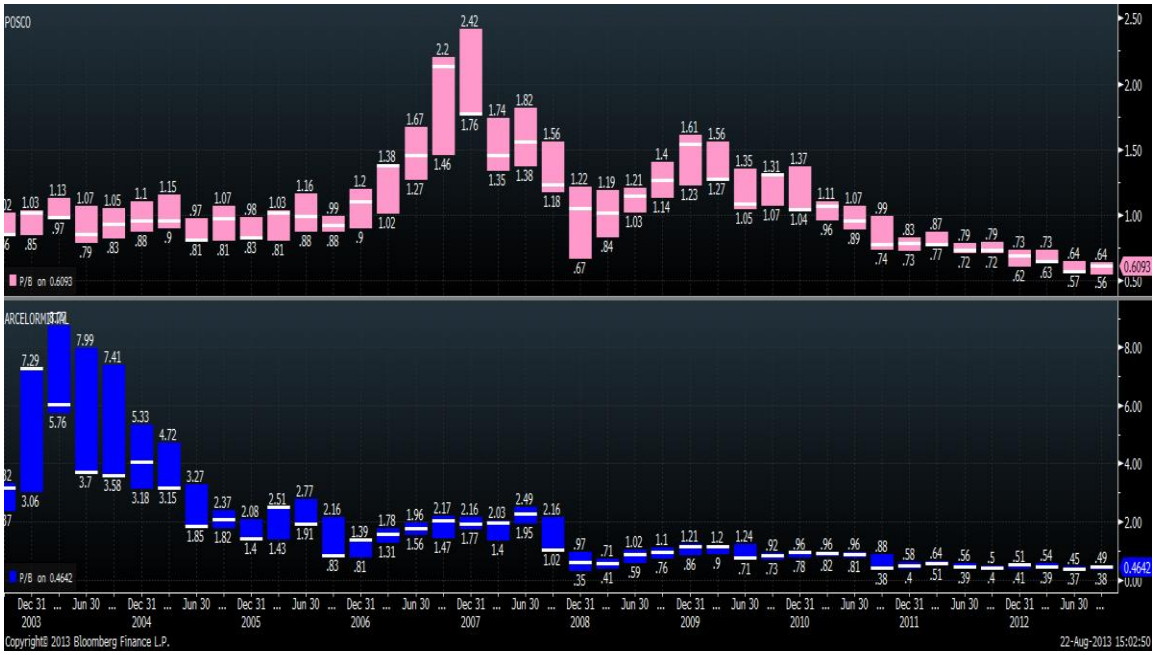
August 22, 2013

STEEL NERVE

To the casual observer it may be difficult to imagine after watching the market averages lift higher during the past year that there is any pessimism left to be found in equities. A natural corollary might be that with share prices higher—namely in the U.S. and Japan though—that the opportunity set for future returns has been diminished. Perhaps valid in a general sense, we believe that once we escape the purview of the U.S. and Japan it is not difficult to locate depressed share prices, and therefore the potential for stock market bargains. As we have noted already this year, one apparently rich hunting ground for bargains can be found geographically located in the emerging markets.

Adhering to our valuation led approach we can also see an obvious clustering of historically low multiples in certain industries, and we believe steel represents a good example. Two steelmakers in particular based in Asia and Europe—Posco and Arcelor Mittal—respectively, show price to book discounts in line with levels last seen during the financial crisis of 2008-2009. In the illustration below we can see the price to book ratios of the two firms over the past ten years. Importantly, Posco (top bar chart) now trades at a price to book ratio of 0.61, which is below its reading of 0.67 in December of 2008, and Arcelor Mittal (bottom bar chart) sitting at 0.38 book is close to breaching its 0.35 level last seen in December 2008.



Source: Bloomberg

Admittedly, the steel industry has been flat on its back in the years since the financial crisis, plagued with over-capacity and weak demand. For that matter, some discount to intrinsic value has a logical basis in regard to *near-term* prospects which is the market's primary concern. If we apply Charlie Munger's paradigm that the stock market resembles a pari-mutuel betting system (i.e., horse racing)—an accurate portrayal, in our view—then it is easy to see how steelmakers have lost shareholder capital at the expense of a multitude of firms in the equity markets showing better near-term prospects or looking more like "a

sure thing." Conversely, the stock market believes that steelmakers look like anything but a sure thing. This helps explain their thoroughly depressed valuations. The market loathes un-sure things.

However, when we examine the full range of the historical valuation comparisons presented earlier, we cannot help but draw skepticism on the market's level of current pessimism. In sum, it appears to have carried too far, and therefore, an opportunity to profit is implied. First, we must recognize the stark economic contrast between late 2008 and mid-2013, or more simply put, the circumstances surrounding the last time steel makers traded at these valuations. In late 2008, the global economy seized up in the midst of a credit crisis, and financial markets collapsed in the wake of the Lehman Brothers failure. In 2013, the global economy is stable by comparison and showing signs of moderate growth.

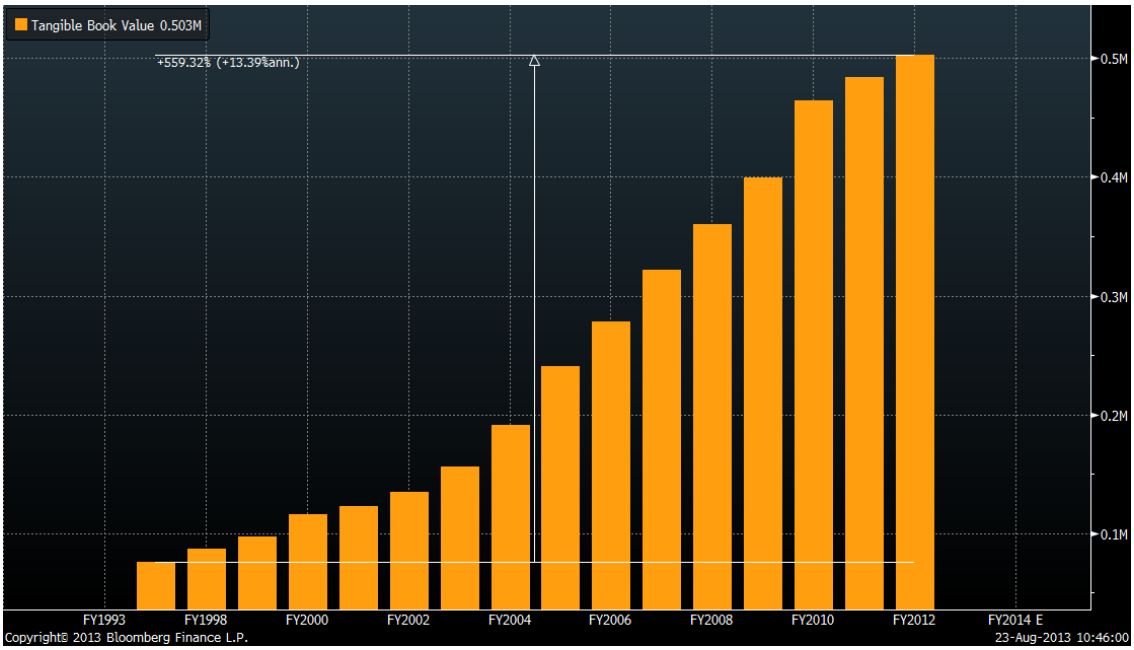
Oddly enough, steel companies in particular are now forecasted by sell-side analysts to recover and resume positive EPS growth in 2014, and yet, current share prices reflect widening discounts to book value that express a level of pessimistic uncertainty not seen since the height of the financial crisis. Essentially, the discounts to book value imply that steel makers such as Posco and Arcelor Mittal will destroy future shareholder value by recording returns on equity below the cost of equity. The opposite circumstance is when share prices trade at premiums to book value per share which implies that value is being added above the cost of equity. Moreover, given the widening nature of the share price discounts, the markets seem to suggest increasingly dire circumstances on par with what investors saw in the looking glass during the depths of the financial crisis.

These market observations beg the simple question, what if future profit conditions are not as bad as these valuations imply, or even improve over the years to come? The answer, we think, brings our earlier discussion of the pari-mutuel system full circle and into sharper focus. The bottom-line is that if, but even more likely *when*, 1.) demand for steel improves and/or 2.) steel supply falls, then 3.) under-absorbed overhead receives right-sized volume, and/or 4.) steel prices rise, then the returns on equity for these firms are more likely to normalize, and the market may again contemplate rewarding the shares with a premium to book value, versus the current discount. To some degree, we believe there is evidence that the fundamental conditions above are progressing, even if slowly.

In any event, and in keeping with the pari-mutuel framework, we believe the pay-off for this alternative scenario (versus the market's current view) is much too large to ignore. Importantly, the discounts to book value trade at a historically wide level, and in our opinion, the grim scenarios that justify these discounts appear to carry lower probabilities than the alternative outcomes that are more positive in nature. This framework represents a classic scenario in value investing, where the downside appears rather limited and the opportunity for upside carries in our view, a higher probability and a larger potential impact on the share price.

This idea is perhaps best illustrated within the context of Posco, the South Korean steel maker. To begin, let us first examine the firm's growth in book value during the past 15 years. In the following illustration we can see that over the course of the past 15 years, which includes the Asian financial crisis, the 2008-2009 financial crisis, recessions, wars, and so on, Posco has managed to increase its tangible book value at every annual stop along the way, culminating in a 13.4% annualized compounded rate of return. The bottom-line is that firm has posted a strong, if not remarkable track record of getting results for its shareholders over a long period of time. In our view, the firm is fiercely competitive and disciplined with its resources as well, carrying the highest rated debt in the industry, and borrowing 10 year debt at a modest 40 basis point premium over Korean sovereign debt. As impressive as the firm's track record may be, since the financial crisis of 2008-2009 however the four year annualized compound rate of return

in the firm's tangible book value has slipped to 8.7% versus the historical 13.4%. We suspect that this lower recent growth run-rate is most likely the starting point for broader pessimism on the shares.



Source: Bloomberg

However, this pessimism appears to have over-shot based on several factors. First and foremost, Posco is not necessarily joined at the hip with the likely over-capacities found in Chinese real estate where construction and demand for long-steel (Posco does not produce) is being affected. Rather, the company's demand is tied heavier to automobiles, ship-building and machinery, lending the ultimate demand drivers more towards consumer oriented channels. With that said, conditions in these end-markets appear to be bottoming and/or improving from a demand perspective. Similarly, recent reports of capacity reductions in China are helpful to all participants in the industry insofar as the right-sizing of supply and demand creates stable to rising prices for various steel products. If we take the view that the underlying steel market fundamentals will continue to improve over the coming years (through a mixture of stable to rising demand and shuttering of excess capacity), then we can also imagine that profit margins and returns on equity may revert back to the longer-term mean historical record. If so, then we can also reasonably conclude that the shares in various steel makers may trade at prices closer to book value. From a back of the envelope sketch of what this implies for shareholders in Posco, if we can assume that Posco can meet the next two years of earnings projections, and after parsing out likely dividends, we arrive at an implied book value of approximately KRW 544,510, and then, should equity investors award a market price in line with book value—given the likely improvements that might have precipitated the earning—this implies +69.6% share price appreciation from today's levels. This is not meant to be an actual forecast, or represent our estimate of intrinsic value for the firm, but only a brief sketch of the underlying logic that can be applied towards the potential scope of share price appreciation. In other words, it takes very little imagination to see the logic behind the case for share price appreciation when shares are priced at these historically depressed levels. To be sure, there are necessary assumptions underpinning this vignette. First, on earnings growth, we simply applied consensus estimates compiled by Bloomberg of 25% growth in 2014 and 3% in 2015. These may appear aggressive at first blush, but

given the high degree of operating leverage in a steel maker's business model, where small changes in sales lead to higher swings in operating income (relative to an aggregate measure of companies across an index), an earnings snapback of this level, or possibly higher, has strong precedent (i.e., 6 annual earnings increases between 34-92% since 1997). Second, it is difficult to know what assets management may decide to sell in the interim period, which could potentially reduce the book value. Otherwise though, it is not hard to see that although the market has placed increasingly long-odds against Posco, and other steel makers (Arcelor Mittal), the patient investor appears to more than likely have the odds well in their favor, the last requisite is of course to possess the nerve to sit tight in the interim.

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