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Lex in-depth: SoftBank's credibility problem

The group's shares trade at a discount but an IPO of its mobile unit could change attitudes

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Jonathan Guthrie and Sujeet Indap DECEMBER 17, 2018

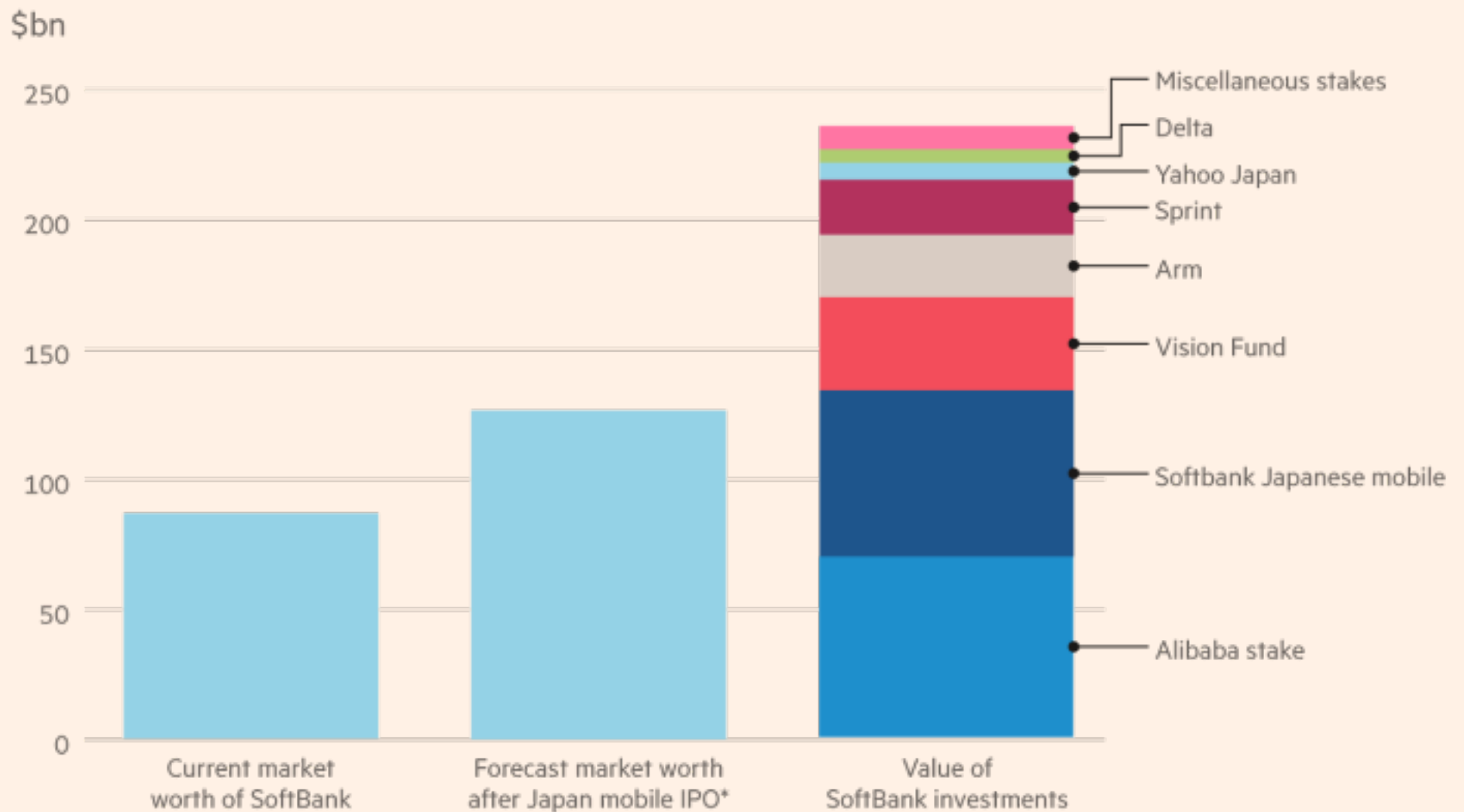
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The “singularity” is the theoretical point at which machines can out-think humans and technological change becomes unstoppable. It justifies breakneck investment in businesses with disruptive potential, according to [Masayoshi Son](#), founder and chief executive of Japanese tech group [SoftBank](#).

“This is the biggest revolution in human history,” he told analysts in August. “Artificial intelligence will change or will redefine all the industries . . . the winners in AI will be winners in the future.”

For the moment, the real singularity is Mr Son. As an iconoclast from consensual Japan, he embodies big contradictions. Fans see him as a tech investment genius. Some traditionally-minded Tokyo business people dismiss him as a reckless chancer.

Japan Mobile IPO is intended to reduce SoftBank’s share price discount



*Assumes market attributes full value to cash raised and that discount for mobile unit closes from over 60 per cent to zero

Sources: S&P Global, FT research

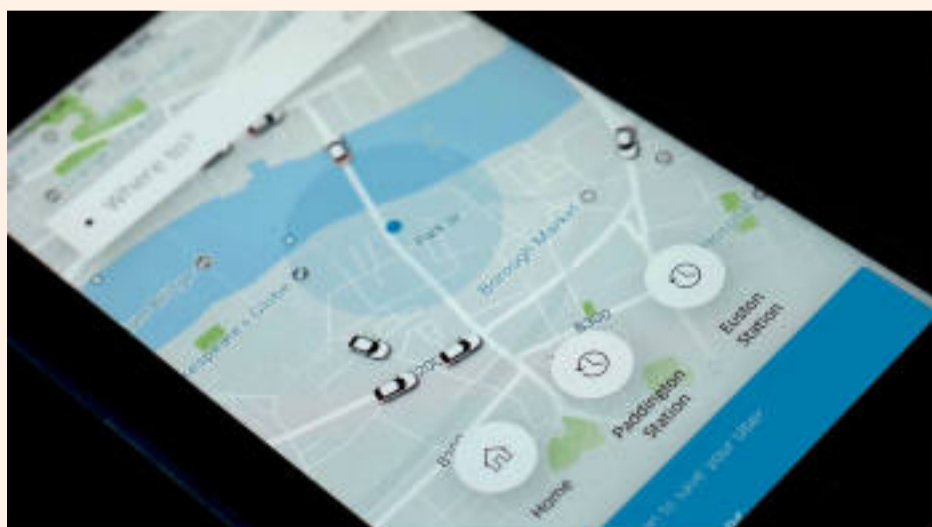
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[SoftBank](#) hopes to undercut hostility with one of the [largest-ever initial public offerings](#). This month the group is floating a [Japanese mobile phone operation](#) with a mooted equity value of more than \$60bn. Executives believe this will reassure investors about the debts carried by the business and trigger a re-rating.

SoftBank is the world's largest focused [tech investor](#). Yet for all Mr Son's futuristic talk, it sometimes buys relatively mature businesses. Mr Son and his fans believe it takes no unhedged risks. Critics decry it in the terms Warren Buffett once reserved for derivatives: as a financial weapon of mass destruction. SoftBank's credibility problem is reflected in a big gap between the value of its investments and the price of its shares.

“They are the buyer of first resort,” says one Asia fund manager, reflecting on the group's fondness for snapping up shares in well-hyped tech plays, such as [Uber](#) and [WeWork](#). “They always want to supersize their investments. They have an issue finding companies willing to take the amounts of money they want to hand out.”

The flotation will bring greater clarity to a tangled structure that reflects Mr Son's restless quest for innovation rather than any conventional corporate strategy. But an FT analysis suggests the move could heighten risks for SoftBank's shareholders and lenders rather than dampen them. Dangers are already understated by the group's optimistic account of its own finances.



The technological evangelism of Mr Son divides opinion. “He is a visionary,” says Dan Baker, an analyst at Morningstar who rates the company a buy. “He is extremely bullish and rarely mentions negatives. Investors are wary of what is not being talked about.”

These include “complexity, opacity and leverage”, according to Chris Hoare of New Street Research. Even compiling a sum-of-the-parts valuation — a simple exercise for most conglomerates — is tricky for SoftBank. But the discount between the impressive value of the group’s investments and its lowly Tokyo-listed shares is over 60 per cent, according to FT analysis of S&P Global data.

The chasm is hardly flattering for Mr Son. It implies his investment skills — or a perceived lack of them — have a negative impact equivalent to \$148bn. The boss of a quoted private equity group in the US or UK could be fired for a discount as big as this.

One part of the calculation involves nothing harder than totting up the value of stakes in listed companies such as [Yahoo Japan](#) and Sprint, a US telecoms business. Another part requires bold assumptions. [Lex](#) followed the lead of many analysts in knocking 30 per cent off the \$100bn market value of a stake in Chinese ecommerce group [Alibaba](#)— SoftBank’s key asset — to allow for tax on any sale. Lex assumed Arm, a chip designer, is worth the full \$32bn SoftBank shelled out for it. By some measures, SoftBank overpaid for the UK business. This is a mature supplier to smartphone makers that has much to prove in a nascent métier: the internet of things.

Deeper controversy bedevils SoftBank’s \$97bn [Vision Fund](#). Saudi Arabia, its largest backer, lost much of its cachet as an investment partner after its agents [murdered](#) journalist Jamal Khashoggi in Turkey in October. Some analysts fear Silicon Valley start-ups will now spurn Vision Fund financing on ethical grounds. Keeping track of SoftBank’s contribution to the fund is a more prosaic difficulty. Lex went with the company’s most recent official valuation of \$35.8bn, implying a jump of almost \$8bn in a few months, though the real value of the shares is in the eye of the beholder.

Paradoxically, the higher the number SoftBank puts on these stakes the greater the dismaying share price discount. No wonder Mr Son is trying to address this. We value SoftBank’s investments at a total of \$235bn, while its market worth is just \$85bn. The difference is partly explained by SoftBank’s substantial net debts but the protection these receive is more fragile than fans acknowledge.



Masayoshi Son with Crown Prince Mohammed bin Salman of Saudi Arabia, the largest backer of SoftBank's Vision Fund. Saudi Arabia lost much of its cachet as an investment partner after its agents murdered journalist Jamal Khashoggi in October © Bloomberg

The flotation of the Japanese mobile business is the first step in a plan to lift market capitalisation. It works brilliantly on paper, inspiring Bernstein analyst Chris Lane to describe it as “alchemy”. Transmuting base metal into gold may be harder in practice.

In the eyes of most Japanese consumers, SoftBank is a mobile phone company with a newsworthy entrepreneur attached. The household name, combined with fat dividends, should lure retail investors. That has emboldened SoftBank Group and its legions of [bankers](#) to attach an aggressive float price to the unit. At ¥1,500 (\$13.20) per share, the telecom company would have an equity value of \$64bn.

The sale of a 37 per cent stake for \$23.3bn should hopefully increase SoftBank's market worth by the same amount. An optimist would expect the shareholding in the mobile operator retained by SoftBank to be priced into its market worth in a similar way.

The gap between the parent's implicit and market values should narrow as a result. This contraction would be helped by a change in stock analysts covering SoftBank from earnings-obsessed Japanese telecoms specialists to asset management analysts, some of them based in the tech-friendly US.

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There are three caveats. First, the re-rating of the retained stake is conjectural, until shares in the phone unit start to trade. Second, Mr Son is likely to sink at least half the IPO proceeds into new tech investments, where their value will once again become opaque.

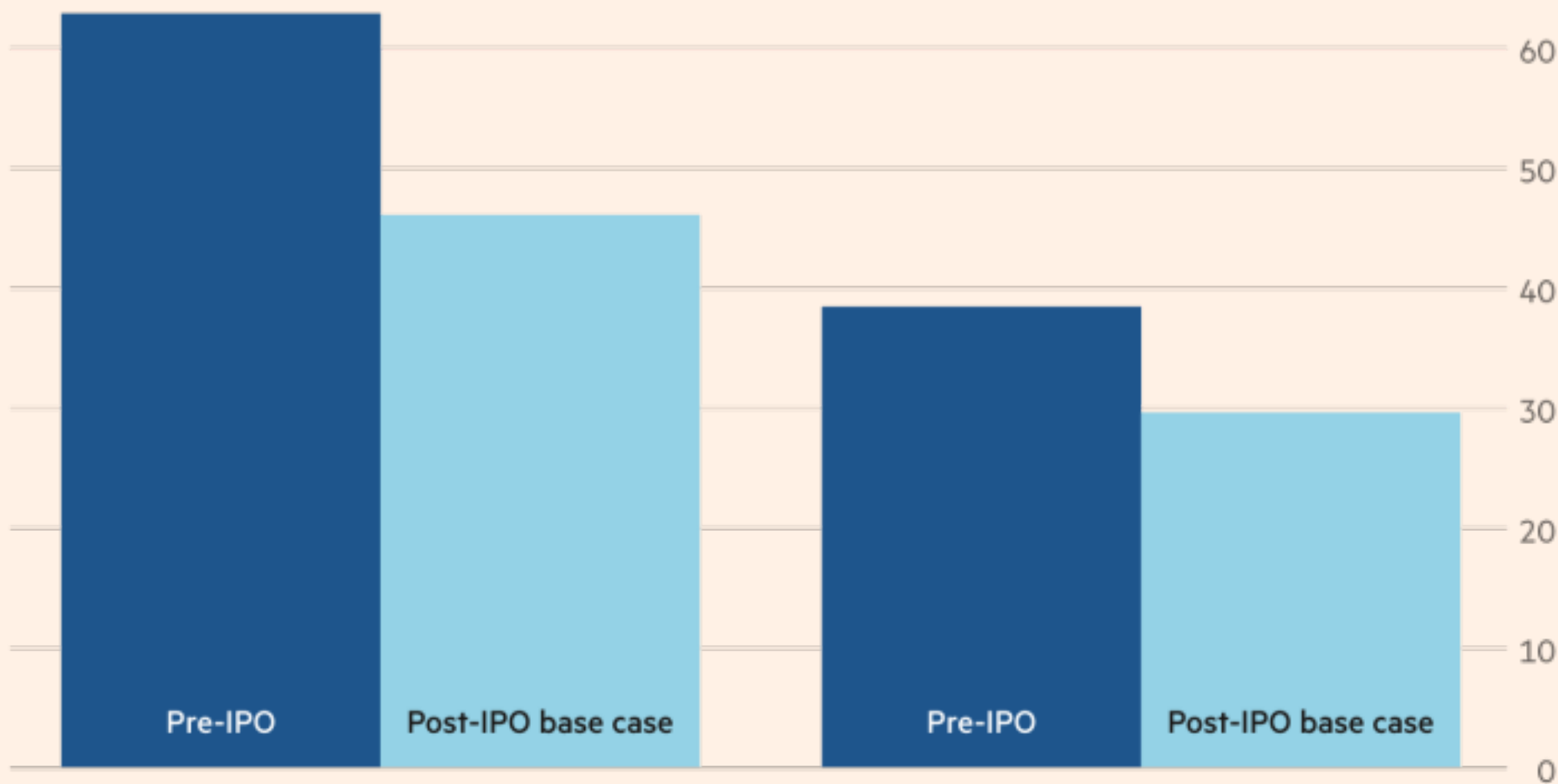
The third caveat is the most significant. The mobile operator is coming to the stock market when a telecoms [price war](#) in Japan is threatening to erupt.

SoftBank Group's racy pricing of shares in its subsidiary is only justifiable if fat dividends from the latter are sustainable. The mobile operator should be able to keep a pledge to pay out 85 per cent of net income. But that will count for little if net income itself is tumbling.

The problem would be more acute for SoftBank Group than the consequent reduction in the value of its shareholding in the phone unit. SoftBank is heavily dependent on cash flows from Japanese mobile phone charges to service its \$130bn net debt mountain.

Mobile IPO aims to unlock value

Discount to value of SoftBank investments (%)



Sources: S&P Global; FT research

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About a quarter of that debt is the result of a sally into US telecoms. In 2012, SoftBank spent \$20bn to buy 70 per cent of the shares of Sprint. Mr Son's plan was to create a telecoms juggernaut to challenge AT&T and Verizon. He hoped to merge Sprint with [T-Mobile](#). But an exercise in empire building became a lesson in humility.

Trust busters blocked the merger. Subsequent events have ominous parallels with the Japanese telecoms industry today. T-Mobile simplified and lowered mobile phone pricing. Tens of millions of subscribers defected from [AT&T](#), [Verizon](#), and Sprint. T-Mobile shares leapt by 120 per cent in the three years to the end of 2017. In that time, Sprint's more volatile stock rose just 42 per cent. Sprint's debt of over \$37bn prompted fears of bankruptcy.

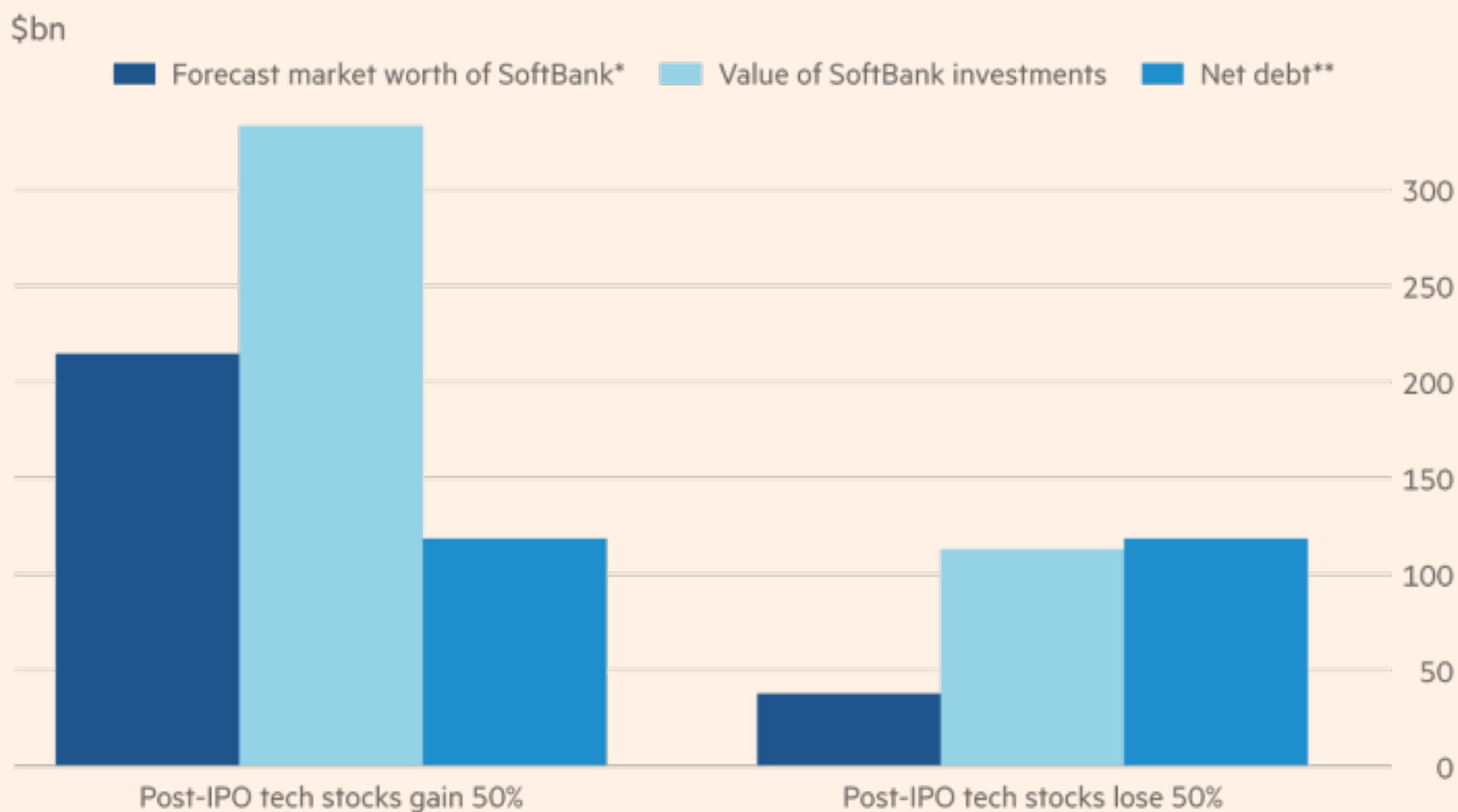
The advent of a more business-friendly era in the US under President Donald Trump encouraged Sprint and T-Mobile to resurrect their merger plan. The new deal terms betray the divergence in the fortunes of the two partners. T-Mobile is now taking over Sprint. SoftBank would go from owning 83 per cent of Sprint to just 27 per cent of the new T-Mobile.

The chances of US competition regulators approving the [all-stock deal](#) this time are put at no better than 50:50 by analysts. If the deal goes through, it would reduce pressure on Sprint's balance sheet. The estimated annual free cash flow of the combined business would be almost \$12bn. A key measure of indebtedness — the ratio of net debt to earnings before interest, depreciation and amortisation — would be less than three times at the new T-Mobile.

The takeover would also lighten SoftBank's bloated net debts to the tune of \$32bn. Accounting rules would permit the group to "deconsolidate" these, which means they would no longer appear on SoftBank's balance sheet.

SoftBank already tends to discount Sprint's debts when challenged on the scale of its liabilities, as do some bullish analysts. This is just one of the ways it downplays borrowings that surpass those of many developing economies.

Fall in tech and telecom stocks would reduce asset cover of debts



*Assumes 1.4 times correlation **Current consolidated net debt

Sources: S&P Global, FT research

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The justification is that Sprint's debts are "non-recourse", which means SoftBank is not liable for them if its subsidiary defaults. SoftBank is likely to apply the same logic to the mobile phone unit's \$30bn of net borrowings after the IPO. This treatment does wonders for that important net debt-to-ebitda metric. The ratio falls from the official level of about five times, which looks steep, to just over three times, which is a lot more comfortable.

Incongruously, the group is happy to include the earnings of subsidiaries and affiliates in its own profits. All the earnings of Sprint and Yahoo Japan go into the pot. SoftBank owns less than half of the quoted internet group's shares, but this is deemed to give it control.

Even a quarter of Alibaba's profits are included, on the arguable basis that SoftBank has a significant influence on the policies of the Chinese group.

This is permissible under Japanese accounting rules. But the inclusions undercut the assumption of some investors that ebitda is a useful measure of SoftBank's cash earnings. Few of the companies in SoftBank's portfolio pay meaningful dividends. Very little of the group's reported net income of \$9.8bn in 2017-18 passed through its hands in the form of hard cash.

Strip out the forecast earnings, as well as the borrowings, of SoftBank's big investments and net debt to ebitda soars to over 10 times. Even a US leveraged buyout specialist would regard this as steep. Strip out the earnings of the mobile phone unit too, to reflect the impending IPO, and SoftBank would be making a loss in some scenarios.

“
Son is extremely bullish and rarely mentions negatives — investors are wary of what is not being talked about

In fairness, the group weaves no cloak of mystery around its accounting policies or its attitudes to risk. SoftBank would like to be better understood. It is an article of faith at the company — and among many debt and equity analysts — that borrowings are comfortably offset by valuable investments, particularly the

stake in Alibaba. Mr Son is wont to joke that “SoftBank has no net debt”.

That share price discount also covers a lot of downside in advance, leaving plenty of potential for capital gains. Mr Hoare says: “You are buying the shares at 60 cents on the dollar, and that dollar could double in value.”

SoftBank shares are highly sensitive to moves in tech stocks. Even privately held businesses such as Uber are sometimes valued in relation to these. If long-term past performance is any guide, a three-fifths rise in new economy stocks could lift SoftBank's shares over four-fifths. That troubling discount would shrink significantly.

The corollary is that if tech and telecom stocks fell by just under a half, it would theoretically cut the value of SoftBank's investments to below that of its consolidated debt. The group's illiquid tech stakes would become hard to sell in a much smaller rout.

Bulls believe in Mr Son's singularity as a tech visionary, as exemplified by his inspired purchase of a stake in Alibaba when it was an obscure start-up. Bears shy away from

SoftBank's key person risk, its impulsive rolls of the dice and big debts. They worry that another definition of a singularity would apply to SoftBank in a market rout: a black hole in space, sucking in and crushing everything in its path. They are right to do so.

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“The sale of a 37 per cent stake for \$23.3bn should hopefully increase SoftBank’s market worth by the same amount. An optimist would expect the shareholding in the mobile operator retained by SoftBank to be priced into its market worth in a similar way.”

Why should it increase its value by 37%? Unless you’re saying its holding is not correctly priced in its current MarCap (accepted) but then why would the uplift on float be the entire proceeds of the sale? Surely some of the value is already priced into the current equity value so the delta can’t be the proceeds on sale. Don’t follow. Am I missing something? Grateful for explanation.

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BeteNoire

4 days ago

Sorry meant to say “Why should it increase its value by the same amount”?

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CH

5 days ago

You need to add net debt to its equity value to calculate the discount vs. EV from sum of all parts. Considering its net debt to EBITDA ratio and the downside potential of its cash flow, investors are quite generous with the current equity valuation. Rainy days are yet to come!

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live twice

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As of 17th Dec 2018, there were 78 companies that went public in Japan.

Of which only six were short of the open price...on the day they were listed.

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SHORT IT SHORT IT SHORT IT

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waffleman

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Here is an in-depth SoftBank analysis that goes into a lot more details about both Masayoshi Son and the company itself: <http://gordoninvesting.com/softbank-new/>

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WattledOak25

5 days ago

Great analysis!

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Douglas Jones

5 days ago

As one comment said, Son made one fabulous investment, Alibaba, and since has added no big value.

So what if that premis is wrong and Alibaba stumbles?

Jack Ma has “retired” to “switch to philanthropy”. Then it comes clear that he is a member of the communist party. He pledged about 10% of his Alibaba stock to a \$2 billion margin loan from Goldman, and bought a 200,000 acre hideaway in the Adirondacs in New York.

Could Jack Ma freely visit China and not risk being “disappeared”?

Already Alibaba is regularly milked by Chinese authorities needing help to bail out other failures. When Facebook can lose 35% of its market value, surely Alibaba has yet to face serious selling.

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Maybe someone can correct me, but as far as I can tell he has only had one gamble which paid off, which is alibaba. Since then he has used it to get a lot of investment, and has since gone on a spending spree, buying overvalued tech companies.

Does that sound about right or did I miss something?

[Report ▼](#)[7 Recommend](#) | [Reply](#)**Jam2Morrow**

5 days ago

@Neanderthal As others have noted, his acquisition on Vodafone Japan/Japan Telecom - which was a basket case - was brilliant...and subsequently his bolt-on acquisition of e-Mobile. That is why he now has the cash generation engine to do all the other stuff.

[Report ▼](#)[4 Recommend](#) | [Reply](#)**Asfan**

6 days ago

My point of view, acid test of Softbanks overall balance sheet is problematic, by taking into consideration of the share volatility of its acquisitions against the gearing factors. So, I see Softbank as a highly volatile tech company heavily relying on politically motivated investment supports.

I recon his political associations probably one of the biggest carnal mistake Mr Son had made and its going to haunt amd bring him down on a public humiliation.

I am an admirer of his entrepreneurialism and hard work. I hope, my gloomy prediction wrong in every way.

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Softbank represents the Dumb Money.

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