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Don't bank on it

Fabiano Santin writes:

Next month, if all goes according to plan, SoftBank Group Corp., the fashion-forward conglomerate founded by Masayoshi Son, will sell a 37% stake in its wholly owned, Japan-based cellphone network subsidiary to the yield-starved Japanese public. To participate in the underwriting syndicate, Son & Co. are asking the investment banks to open their wallets to lend to itself, the selling shareholder. It's a strange request or, perhaps, demand, to be sure. Equity stakes in various tech-related stocks, including Uber Technologies, Inc. (*Grant's*, Nov. 2), will furnish the collateral. "All we can do is stay in the game," one compliant banker resignedly tells the *Nikkei Asian Review*.

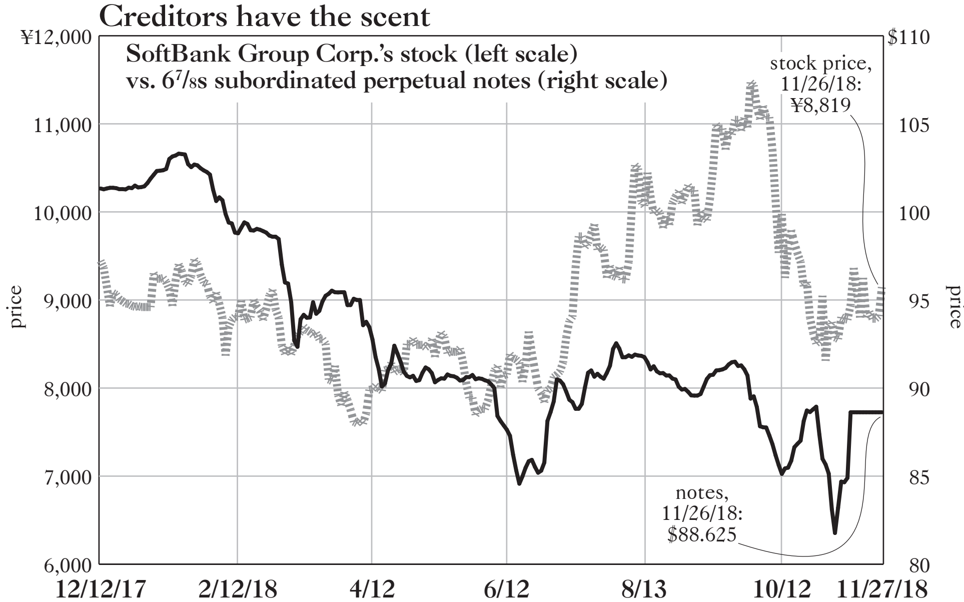
If there were a corporate epitome of today's frenzied finance, *Grant's* holds, SoftBank would be the one (see the issue dated Dec. 15, 2017). It's not because of the size of the company's debt alone—AT&T, Inc., which owes $183 billion in recourse liabilities, makes SoftBank, on the hook for $77 billion, seem a bit of a piker. Notoriety rather stems from the uses it makes of its cheaply acquired leverage, especially that of dominating today's trillion-dollar market in profitless tech start-ups. The conglomerate is about to go all-in, retreating from telecom to sharpen its focus as a collector of illiquid technology businesses. It's in this context that SoftBank's significant, cash-generative, wholly owned cellphone subsidiary is soon to go missing.

Since the analysis in these pages almost one year ago, SoftBank shares have fallen by 7%, to trade at ¥8,819, while its dollar-denominated subordinated perpetual bonds have dropped to $88\frac{5}{8}$, from 102 cents, to offer an 8.7% yield to call in July 2027, or 582 basis points over Treasurys. We remain bearish on the shares (ticker 9984 in the Tokyo Stock Exchange and SFTBY in the American pink sheets), a little less bearish on the debt, given how much wider its credit spread has become. There's been no markdown in sentiment among the sell-side equity analysts that Bloomberg surveys: Ten out of ten say "buy."

The bull case for SoftBank rests on the contention that the shares imply a 37% discount to its holdings (see tables nearby) and that Son retains the miracle touch by which he transformed a $20 million bet on Alibaba Group Holding, Ltd. (BABA on the Big Board) 18 years ago into an after-tax mark of $85 billion today. Aside from Alibaba, SoftBank holds roughly $120 billion in stocks ranging from old-tech Yahoo! Japan Corp. to multibillion dollar unicorns ensconced in its majority-owned, $97 billion Vision Fund, Uber and WeWork Cos., Inc. among them.

Recent financial results dazzle the eye, though not the analytical portion of the brain: Operating income for the six months ended Sept. 30 climbed to ¥1.4 trillion ($12.6 billion) from ¥875 billion ($7.7 billion) in the equivalent period last year. Net income leapt to ¥871 billion ($7.7 billion), from ¥144 billion ($1.27 billion) one year ago. High and difficult-to-justify valuations explain much of the upsurge.

Creditors have the scent



source: The Bloomberg

Of course, the risk of high valuations is financial gravity, a force much in evidence in the autumn slump on the Nasdaq. Fattening operating income was a $1.5 billion gain booked from flipping a 20% equity interest in Flipkart Pvt. Ltd., an Indian e-commerce firm, and a $4.4 billion unrealized gain from the rise in, among other things, NVIDIA Corp., the California maker of graphics-processing units, which, having ridden the crypto-mining boom to the upside, is now symmetrically riding it to the downside (*Grant's*, June 29).

Up next is the imminent IPO of Japan's third-largest mobile-network provider. Initial price talks value the enterprise at ¥10.2 trillion ($90 billion), or 8.2 times adjusted earnings before interest, tax, depreciation and amortization (EBITDA). This valuation multiple would be more than 60% above the average of peers NTT DoCoMo, Inc. (5.5 times) and KDDI Corp. (4.4 times), Nos. 1 and 2 in Japan with a combined 75% market share in mobile revenues. The IPO could yield ¥2.4 trillion ($21.3 billion), which should raise the question of why SoftBank needs loans from its underwriters.

To attract retail investors, SoftBank is promising a high payout ratio (85% of earnings vs. the competitors' average, 48%) to support that 5.5% dividend, a handsome pickup on 2% yield on the Nikkei stock index and the virtual zero return available in a host of Japanese government bonds. SoftBank will continue to consolidate the financials of the Japanese telecom provider, but it will have access to that subsidiary's cash only through dividends. It would be entitled to about ¥265 billion ($2.3 billion) in annual dividends, enough to barely cover the roughly ¥228 billion ($2 billion) in interest costs.

It bodes nothing very bullish for SoftBank that, on Oct. 30, DoCoMo announced plans to slash monthly rates by as much as 40%, effective April 1. Claiming that Japanese cellphone customers pay the highest rates in the world, Tokyo has been hounding the carriers for relief. The day after, DoCoMo cried uncle, that the combined market cap of the three players slumped by ¥3.8 trillion ($34 billion). A fourth player, Rakuten, Inc., plans to join the trio with aggressive pricing in October 2019. You don't need to be a mind reader to guess why Son chose to bring his cash cow to market now, remarks Amir Anvarzadeh, Japanese equities strategist at Singapore-based Asymmetric Advisors Ltd.: One year hence, he contends, the business will certainly be weaker and its equity valuation lower.

While a new entrant is coming to the hitherto three-player Japanese market, Son is pushing for relief in America, where SoftBank owns 84.5% of Sprint Corp. (worth $21 billion; 41 million retail wireless subscribers). Sprint competes against T-Mobile U.S., Inc. (61 million subscribers), Verizon Communications, Inc. (116 million) and AT&T, Inc. (93 million). If the Department of Justice and the Federal Communications Commission confer their blessings, Sprint will proceed with its long-planned merger with T-Mobile, thus to transform the United States into a three-player market.

"Under normal circumstances, it is a tough deal to get through the agencies," an antitrust expert tells *Grant's*, cautioning for possible market disappointment. "There is a very weird dynamic at play here which I have not seen too many other times . . . frankly, ever," our source says, referring to the relatively high 60% implied probability that the deal gets approved even though merger-arbitrage traders are shying away from it.

Before merger talks, at the start of 2016, Sprint's five-year credit default swaps implied a nearly 80% probability of default. The carrier's leverage, adjusted for operating leases and pension and healthcare benefits, stands at 4.8 times adjusted EBITDA, according to estimates by Craig Moffett, one-half of the eponymous research firm MoffettNathanson LLC. If Sprint's market cap were to fall to early-2016 levels, SoftBank would suffer a 15% hit to *its* market cap.

The drag in Alibaba's stock mostly explains SoftBank's lackluster share-price performance this year. At $111 billion before prospective capital-gains taxes, the position is larger than SoftBank's own market cap of $80 billion, a fact that underlines Son's dependence on the People's Republic. The 10% decline in Alibaba's stock in the six months ended Sept. 30 represents

SoftBank at a glance

SoftBank Group Corp. holdings as of Nov. 26, 2018	—in $ millions— carrying values after tax	adjusted values
Alibaba	$85,015	$68,012*
Japanese telecommunications subsidiary	30,815	19,091**
Sprint	21,328	21,328
Yahoo! Japan	5,229	5,229
ARM	24,000	24,000
Uber, DiDi, Grab, Ola, GM Cruise, etc.	27,504	27,504
Vision and Delta Fund	10,730	10,730
total	**204,621**	**175,894**
market discount to SoftBank holdings	37%	27%

SoftBank financials as of Sept. 30, 2018

total debt	$76,468
consolidated cash	28,051
plus sale of Japanese telecom stake†	17,989
less Sprint, Yahoo! Japan and SoftBank Corp. cash	-11,881
parent cash	34,159
net debt	42,309
SoftBank Group Corp. market cap	85,812
enterprise value	128,121

* Assumes a 20% liquidity discount.
** Assumes a six-times adjusted EBITDA multiple.
† Assumes a Japanese capital-gains tax rate on the full amount.

sources: company financials, *Grant's* estimates

$14.1 billion in unrealized losses, compared with the $7.7 billion in net income reported for the period. Losses and gains related to fluctuation in BABA do not flow through SoftBank's income statement because its stake is reported under the equity method of accounting; SoftBank rather reports its 29% share of Alibaba's net income.

To divest its entire Alibaba position, SoftBank would need 180 trading days if it limited itself to 20% of the average trading volume. At 30 times 2019 earnings, the Chinese Amazon looks richly valued beside the 10-times multiple offered on the MSCI China Index—or even the 24-times for the FAANG index.

When SoftBank had cash to invest, it was instrumental in setting the lofty valuations prevailing on such unprofitable ventures as the ride-hailing constellation of Uber, Xiaoju Kuaizhi, Inc. (DiDi), Grab Holdings, Inc. and Ola. As cash flow dwindles following the telecom IPO, someone else must step into the breach, lest the implied market cap of these and other unicorns flutter down from heaven for a lack of aggressive bidding.

In March, Uber sold its Southeast Asian operations to Grab, while SoftBank allegedly tried to broker a merger of Uber's Indian operations with Ola. Two years ago, Didi bought Uber's China business for an equity stake in the new entity. Meanwhile, Uber competes head-to-head against Didi's business in Brazil and Mexico among other places. Local authorities could have a say in the regulation of these profitless, cannibalistic businesses vying to run an oligopoly, which seems to be the thesis behind SoftBank's investments. It is perhaps telling that, in a Nov. 25 *Financial Times* article, Rajeev Misra, CEO of SoftBank's majority-owned Vision Fund, cautiously uttered, "it's up to the companies" to decide on consolidation because "competition issues" could make mergers unattainable.

Less circumspect was Misra explaining that overpaying by "10% or 20%" for investments make little difference since the Vision Fund aims to return "three to four times the investment." Misra is unlikely to believe that he knows how to value these loss-making businesses within a 20% margin, but the affirmation is revealing because it shows the hubris behind SoftBank's approach.

Despite the 37% discount the shares offer to SoftBank's holdings, Son will be in no hurry to disassemble the conglomerate to realize that discount and, even if he were, many of SoftBank's equity interests are based on prices that SoftBank itself paid. For instance, on Aug. 24, 2017, SoftBank invested $3 billion in WeWork, valuing the startup office-rental firm in "the high teens" of billions of dollars, according to Forbes (*Grant's*, Nov. 16). On Nov. 13, another $3 billion investment from SoftBank valued the unicorn at $45 billion. Assuming that IFRS rules allow, SoftBank may be able to mark up paper gains attributed to the difference between last year's valuation and this latest round's.

If we took a 20% haircut in BABA due to the lack of liquidity and assume a more reasonable valuation of six-times adjusted EBITDA for the Japanese telecom subsidiary, the aforementioned discount of 37% narrows to 27%. Never mind: Neither would even an apparent 37% discount provide a true margin of safety. A short list of risks confronting SoftBank would include a potential failure in merging Sprint with T-Mobile; a slowdown in Chinese economic growth; a carve-up of Alibaba by the new Chinese tyrant for life, Xi Jinping; more intense competition in the Japanese telecom market; a realization on the part of investors everywhere that the unicorn is, in fact, a mythical beast and that profitability is the inherent attribute of business success.

More than the epitome of frenzied finance, SoftBank is the canary of the cyclical coal mine. For that reason, if no other, we worry about its health.

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