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# Epitome of the cycle

Masayoshi Son founded what is today Japan's fifth-largest listed company, SoftBank Group Corp., in 1981. By good fortune, it was the same year in which interest rates started their long, lucrative descent. We write to propose that Son's telecommunications-cum-asset-management-cum-techno-conglomerate owes as much to the bull bond market as it does to digital invention. In this sense, SoftBank—for all its exposure to e-commerce, artificial intelligence, ride-hailing and the like—is a kind of credit instrument itself. Rates down, price up—and vice versa.

The curious and worldwise subscribers to *Grant's* need no persuading to interest themselves in the affairs of a mammoth, leveraged, complex and speculative business, albeit one headquartered in Tokyo, not New York. One of these days, perhaps when the credit markets take an unscripted header, SoftBank may make the wrong sort of headlines. If so, the consequences could ripple far and wide. It would be well, then, to know something about the structure, ethos and vulnerabilities of this boomtime institution. Consider:

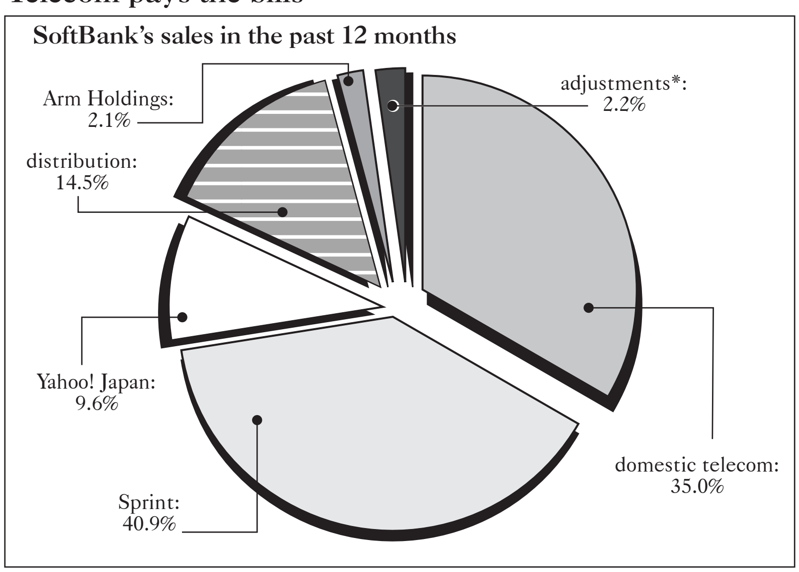
SoftBank (designated 9984 on the Tokyo Stock Exchange and SFTBY in the American pink sheets) is embarked on a worldwide buying and borrowing spree at what is certainly not the bottom of the market. It's a prolific issuer of high-yield debt, including the single-B-plus-rated 6s and 6 7/8s subordinated perpetual notes (the payment of whose coupon management may defer at its option). It owns 83% of Sprint Corp. (*Grant's*, Dec. 23, 2016). It is the sponsor of an unorthodox $100 billion venture-capital fund. It owns 30% of Alibaba Group Holding, Ltd., the Chinese retail, e-commerce and technology behemoth (BABA on the Big Board; *Grant's*, April 22, 2016). On this sprawling and omnivorous enterprise—a kind of avatar of Everything Levitation—we are bearish.

Many are bullish on SoftBank and, perhaps especially, on its hyper-intelligent, ever-restless CEO. "There are very few places he can go and not be the smartest guy in the room," says Ray Klein, independent investor and paid-up subscriber. "He's truly brilliant, and he has boundless energy."

To be sure. In the late 1970s, while studying economics at the University of California, Berkeley (having completed his American high school career in two—yes, two—short weeks), the young entrepreneur invented an electronic dictionary which he sold to Sharp Corp. for $1 million. Returning to Japan, he founded his business with the help of a friendly branch manager of the Dai-ichi Kangyo Bank who advanced him $750,000 against no collateral and perhaps $10,000 of annual revenue. With such persuasion as we can only imagine, Son assured the man seated across the table that the personal computer and the software inside it were the wave of the future.

In 1995, Son bought a 35% stake in Yahoo!, Inc. for $100 million. More than that, he midwifed the creation of

**Telecom pays the bills**




*Consists of other revenues and reconciliation of intersegment sales.
source: company data

Yahoo! Japan Corp., in which joint venture SoftBank retains a 43% position now valued at $11 billion.

Disappointed by the Japanese government's refusal to grant SoftBank the spectrum it needed to compete in wireless services, Son managed to do the seemingly impossible: In 2006 he bought Vodafone Japan for $20 billion, borrowing $18 billion of the purchase price. Once more, he persuaded Japanese lenders to trust him, in this case to slash prices, improve network quality and take market share from the incumbents, which he proceeded to do.

"And then," colleague Fabiano Santin relates, "there is the investment that so far outshines all others. In the year 2000, Son saw opportunity in Alibaba and invested $20 million in it. Today, that stake in the Chinese e-commerce, retail and technology giant is worth $134 billion. Since its 1998 debut on the Tokyo Stock Exchange, SoftBank's stock has delivered an 18% annual return in dollars (17% in yen), compared to 3% for the Nikkei (2.4% in yen) over the same span. Vitaliy Katsenelson, chief investment officer of Investment Management Associates and a SoftBank investor, in 2015 inquired of the readers of his Contrarian Edge blog, 'What would you get if you crossed Warren Buffett, Richard Branson and Steve Jobs? Answer: Masayoshi Son.' Bernstein Research echoed those words in an Oct. 19 research bulletin: SoftBank is 'the Berkshire Hathaway of Tech.'"

So Masa Son's track record speaks for itself, the bulls say (21 buys, 3 holds and zero sells is the way the sell-side lines up, according to Bloomberg). Besides, the argument goes, the shares trade at a 40% to 50% discount to the sum of the corporate parts. Of this value-themed contention, more in a moment. We would remind the enthusiasts that the price of SoftBank shares registered a 99% decline at the close of the 1990s tech bubble (to ¥276 in 2002, from the all-time high of ¥20,222 on Feb. 18, 2000). No loss in the founder's formidable IQ explained it. Valuation, crowd psychology, illiquidity and the cycles of finance rather played their customary parts. Such forces are recurrent. They have certainly helped on the upside.

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SoftBank is a holding company with a $92 billion market cap, $79.6 billion in trailing 12-month revenue, $23 billion in adjusted earnings before income, tax, depreciation and amortization (EBITDA), $137.6 billion in consolidated debt and $30.5 billion in cash. The company brings together 761 subsidiaries, such as the Japanese telecom business (34.7% of revenues), Sprint (40.7%), Yahoo! Japan (9.6%), Brightstar Global Group, Inc. (14.6%), Arm Holdings, plc (2.1%) and others (1.6%). It reports its 30% Alibaba stake along with 129 other associates as equity-method investments. It owns $24.6 billion in minority stakes in hundreds of companies ranging from China's ride-hailing Xiaoju Kuaizhi, Inc., a.k.a. Didi ($5 billion invested), office-rental network WeWork Companies, Inc. ($4.4 billion), online sports-apparel retailer Fanatics Holdings, Inc. ($1 billion), biopharmaceutical company with a bet on artificial intelligence, Roivant Sciences Ltd. ($1.1 billion), "insuretech" firm ZhongAn Property and Casualty Insurance ($500 million), and lots of other speculative plays.

Thus, the corporate vital signs. Now to disaggregate them. Neither debt nor revenue, as presented in the consolidated financial statements, is exactly what it seems. As to debt, some $63.5 billion of the obligations of Sprint, Yahoo! and other subsidiaries are nonrecourse to the parent. Concerning revenue, SoftBank books 100% of the top line of Yahoo! Japan, though it owns only 43% of the equity of that subsidiary (as IFRS accounting conventions allow). There is accounting-induced misapprehension, too, with respect to Sprint. The parent consolidates the telecom subsidiary's revenues and EBITDA, again in conformity with IFRS. Reading those figures, an investor may assume that the funds are the parent's to use as it sees fit. The truth is the opposite. Sprint is an equity investment that may or may not pan out. Its revenue and cash flows (currently cash-burning) may never be available to SoftBank. The essence of SoftBank today—distinct from the dreams of tomorrow—is the Japanese telecom business, which (excluding Sprint and Yahoo!) generates 70% of revenues and 100% of EBITDA.

Even after stripping away the nonrecourse portion of the debt, SoftBank owes $76 billion. Whether that is a little or a lot depends, of course, on the assets that furnish the cash flow which pays the interest, on the terms and conditions under which the debt was incurred, on credit spreads and interest rates. Notable is that the size of the debt has jumped to $76 billion from $52 billion in only the past 18 months. Amir Anvarzadeh, head of Japan equity sales at broker BGC Partners Ltd., in Singapore, tells Santin, "I think Son is not as much of a genius as some other people think he is. I think one of his genius virtues is the fact that he has access to cheap money. . . . I give him that. He has access to a lot of retail money where he can actually issue bonds domestically to the retail investors and raise money at fairly low rates."

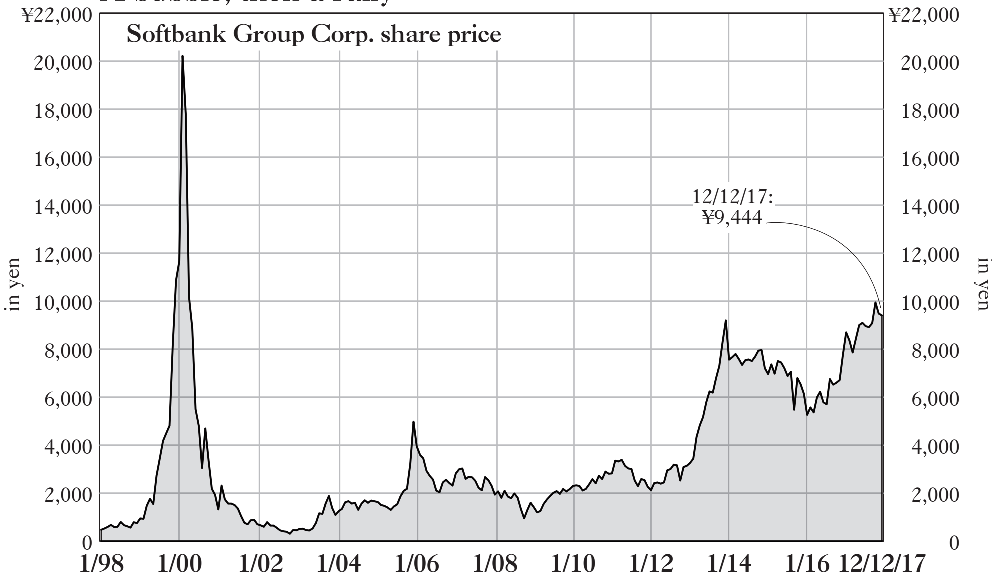
To be precise, SoftBank is paying 2% on the $31 billion which its Japanese creditors advanced. An equal-opportunity borrower, the company is likewise issuing debt in euros and U.S. dollars. In July it sold $4.5 billion of the aforementioned subordinated perpetual notes, which S&P rates single-B-plus, three notches lower than the SoftBank unsecured bonds (two notches owing to subordination and another on account of the issuer's option to defer interest payments).

As mentioned, it's the Japanese telecom operations that generate the cash that pays the bills. For the 12 months ended Sept. 30, that key division produced adjusted EBITDA of $10.3 billion, down from $10.7 billion in the like period a year ago, at constant exchange rates. Thus, SoftBank's leverage is a meaty 7.4 times adjusted EBITDA, up from 6.5 times a year ago. Leverage is heading higher as SoftBank invests to prepare for better network coverage and to keep up with the Joneses named NTT Docomo, Inc. and KDDI Corp.

In neither the United States nor Japan is SoftBank more than a telecom also-ran. Sprint is the fourth-largest wireless carrier in America. SoftBank's telecom business is the third-largest in Japan, where it commands a 27% share of revenue vs. 40% for Docomo and 33% for KDDI.

At last report, $6.1 billion in trailing 12-month operating income for the Japanese telecom business covered interest expense, at the holding company, by a factor of 4:1. Squinting into next year, management projects a coverage ratio closer to 3.6:1. The dip is attributable to the rising investment required to increase network

A bubble, then a rally



source: The Bloomberg

coverage and stay current with the growing demand for data transmission. Meanwhile, as Bloomberg reported on Dec. 1, the Japanese government is leaning on operators like SoftBank to reduce their customer charges.

Sprint is unlikely to prove Son's shrewdest investment, whatever the final reckoning. For its 83% portion of the wireless provider, SoftBank paid $22 billion in 2013. At the current Sprint share price of $5.50, that stake is worth $18 billion—or less. Telecom specialist Craig Moffett, founder and one-half the eponym of MoffettNathanson Research, forecasts that Sprint will burn an average of $3.5 billion for each of the next four years while facing average debt maturities of $4.3 billion per year until 2024. So reckoning, Moffett pegs the value of the stock at $2 a share, implying an $11 billion haircut to the sum-of-the-parts calculations on which the bullish case for SoftBank partially rests.

"Masa Son has already stated that the United States is his most important market," Santin notes. "He has high hopes for the 'internet of things,' too, which relies on wireless services. In October, SoftBank held merger talks with T-Mobile, the third-largest American carrier. Negotiations reportedly broke down over the refusal of the famously hands-on Son to cede control of the combined entity. The failure seemed to confirm Son's intention to keep the Sprint stake at any cost instead of selling it or reaching a deal to speed up the generation of synergies to deleverage, as some investors thought he could, or should, have done. Expect, then, more cash infusions into the needy American carrier."

Yahoo! Japan, in which SoftBank owns the previously mentioned 43% stake, is suffering an operational droop of its own. For the first half of 2017, adjusted EBITDA fell by 8.4%, to $956 million, from $1.04 billion in the year-earlier stretch. EBITDA as a percentage of revenue has plummeted to 25% from nearly 50% in 2014, in which year the subsidiary's share price peaked.

Weaned in bull markets and imbued with entrepreneurial optimism, Masa Son doesn't mind writing big checks. He paid a 43% premium to the market price, and a 65 times earnings multiple, to secure Arm Holdings in last year's $32 billion acquisition—the investment is said to have dumbfounded even those close to the man who made it. Arm earns royalties by licensing microprocessor designs to chip makers and reflects Son's bet on artificial intelligence, augmented reality and the internet of things. A sign of the CEO's commitment to this particular wave of the future is that R&D spending and new engineering hires are both on the upswing (head count is up by 27% in the past year, to 953 employees). Profitability will have to wait.

WeWork, at least, books revenue, as much as $1 billion a year, even if there is no net income just yet. In August, SoftBank invested $4.4 billion in the freelance office-rental outfit at a $20 billion valuation, according to *The Wall Street Journal*. For its part, WeWork has purchased stakes in a maker of wave pools, Wavegarden; in a fitness club, Rise by We; and in a coding academy, Flatiron School. The unicorn is also preparing to close on the $850 million purchase of Lord & Taylor's flagship store in New York City, space which one year earlier bore an appraisal of $650 million.

SoftBank's purchase, in February, of Fortress Investment Group for $3.3 billion, a 38.6% premium to the previous day's close (*Grant's*, Feb. 24), likewise fits the acquisitive, open-handed, sometimes strategically puzzling pattern. It's unclear how a private-equity/hedge-fund manager fits into Son's strategic picture, unless, as Santin suggests, the technological visionary is striving to become the Earth's largest asset manager. Which brings us to the SoftBank Vision Fund.

There has never been anything quite like it—no fund so big, none (of any remotely comparable size) so leveraged. As of Sept. 30, capital commitments were within a few trivial billion of $100 billion—Saudi Crown Prince Mohammed bin Salman, a.k.a. MBS, reportedly circled $45 billion. In toto, third-party investors were on board with $65.2 billion, consisting of $24.8 billion of equity and—this is where the leverage comes in—$40.4 billion of 7%, payment-in-kind preferred. SoftBank is contributing $32.5 billion in equity. There's a five-year investment period, and a minimum life of 12 years.

The general partner—that's SoftBank—charges a management fee of 0.7%–1% and a performance fee of 20% for returns above an 8% hurdle rate, according to the *Financial Times*. At 1% on the $24.8 billion in third-party equity, the management fee just barely covers operating expenses (running at an annual rate of $198 million since the fund launched on May 20).

What could hurt the limited partners more than management fees are the dynamics of the payment-in-kind structure. In a bear market, or even a blah market, it's possible for the accrued interest on the preferred shares to snowball. The longer a period of substandard performance lasted, the worse it would be for the equity holders. And substandard is the norm if you overpay for investments. Recall that Arm, which will represent about 8% of Vision's assets, did not come cheap. Its 65 times

P/E multiple equates to a 1.5% earnings yield, and even that seems optimistic. The royalty-licensing company delivered a $130 million loss in the six months to Sept. 30, as SoftBank reported.

Does Son have another Alibaba up his sleeve? The fund isn't wanting for boldface names that seem to think so. The roster of limited partners features Public Investment Fund of the Kingdom of Saudi Arabia, Mubadala Investment Company of the United Arab Emirates, Apple, Inc., Foxconn Technology Group, Qualcomm, Inc. and Sharp Corp.

In its 2016 annual report, SoftBank invited its stockholders to compare Vision, at nearly $100 billion, to the $64 billion that venture-capital promoters the world over had raised in the just-completed 12 months. The comparison, flattering to itself, glided over one small detail. "[Vision] is not a venture-capital fund," Steven Kaplan, Neubauer Family Distinguished Service Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business, tells Santin. "It's a growth equity/buyout fund, so it's [misrepresented], and you see the deals that they've invested in are really too big to do much early-stage stuff. It's four times bigger than the biggest private-equity fund."

You can't say that Son is investing in the unknown. SoftBank's equity contributions to the Vision Fund (so far) largely consist of positions in existing SoftBank portfolio investments, including Arm ($3.8 billion) and Didi ($3.6 billion). Hence, such in-kind transfers totaled $7.4 billion through Sept. 30, from a total of $32.5 billion that SoftBank has committed. Might some fear that the parent could use Vision as a dumping ground for SoftBank's less inspired ideas? To allay any such concerns, Son has agreed to contribute not just some, but any, investment over $100 million to the Vision portfolio.

"Still," Santin observes, "a SoftBank shareholder, having invested in company stock because of his confidence in Son, is now seeing his original investment being diluted on some of SoftBank's core bets (ride-hailing and Arm, for instance). And whatever great opportunity, if any, comes knocking on SoftBank's door, that investment will have to be shared with the Vision investors. If one makes the argument that the fund actually helps SoftBank shareholders by allowing Masa Son to drop his dogs into the fund, what does that say about the chairman, who has assumed a fiduciary duty to his third-party limited partners? Furthermore, will competitor companies outside the fund make it more difficult to cooperate with the fund's investees? Why should Waymo, Google's self-driving car company, make its technology more accessible to Didi, which is now partly owned by Apple through the Vision Fund? Apple, after all, is developing its own self-driving vehicles. Will this massive investing machine come back to bite SoftBank in unforeseen ways? Today's technology industry is much more competitive than it was even 15 or 20 years ago, when Son was in his glory."

There's been nothing more glorious—to date—than Alibaba. Sum-of-the-parts analyses value BABA at $134 billion (market value), compared to $60 billion for the second most important piece, the Japanese telecom unit, and $18 billion for the third-largest subsidiary, Sprint. What might these parts be worth to SoftBank?

After applying the Japanese capital-gains rate, 23.4%, BABA deflates to $103 billion. Add Japanese telecom and Sprint, and you get $181 billion. Combine with another $60 billion, representing the estimated value for all remaining assets. It comes to $241 billion in assets against $61 billion in net debt.

"Asset values are contingent, but debt is forever," was a rueful epigram that came out of the junk-bond crackup of 1989–90. Variable and volatile, certainly, is the value of Alibaba, which appreciated by 90% in the past year. This meant $212 billion in incremental wealth for Jack Ma's shareholders, $64 billion for Son's (i.e., 30% of $212 billion).

"Observe that, in the same 12 months," notes Santin, "SoftBank's stock rose by 23% in U.S. dollars, which meant 'only' $17 billion in additional value. Looking from a different perspective, since the IPO of September 2014, BABA short sellers would have suffered the 157% surge in share price, while SoftBank short sellers would have more than survived the 5.6% SoftBank increase during the period—and that's despite SoftBank's ¥500 billion ($4.5 billion) buyback in 2016 that retired 8.3% of shares outstanding. In the past three years, the market hasn't been generous to SoftBank's stock and now, because of BABA's meteoric rise (and thus SoftBank's increasing exposure to it) and the Japanese company's growing debt levels, a fall in BABA could deal a significant blow to Masa Son."

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Critics of Alibaba harp on related-party transactions, borrowing to fund money-losing affiliates and the dissemination of potentially misleading operating metrics, such as overstated gross merchandise value. Alibaba, too, makes many seemingly random investments, sometimes in harness with SoftBank, its No. 1 shareholder; Didi and SoftBank's robotics business are examples. In June 2016, Alibaba and its management team ("the Alibaba Partnership," comprising 36 members of Ma's inner circle) purchased $2.4 billion worth of BABA at a price of $74 per share. They bought it directly from SoftBank.

A less obvious risk to SoftBank is Mr. Market's evident reluctance to afford Softy the benefit of the doubt. "First, show me the money," is the gentleman's message nowadays. The so-called singularity, the future jubilee in which artificial intelligence surpasses human intelligence, is one of Son's preoccupations. When it will come (if ever it does) is anyone's guess. Anyway, investing in millennial story stocks may not be the safest course in a late-cycle market, especially using leverage. "I'm concerned that at some point Masa Son may drink a lot of Kool-Aid and then he may leverage the company a lot more than I'd like," a skeptical Katsenelson tells *Grant's*.

Where are the chinks in SoftBank's armor? Not short-term funding, we think. As of Sept. 30, SoftBank Group (ex-Sprint and Yahoo! Japan) owed $23.6 billion maturing in the next 12 months. Of that grand total, $9 billion was a bridge loan (it financed the Arm acquisition), which, by now, if all went according to plan, has been converted to long-term bank debt. If so, SoftBank should have no pressing short-term obligations—the remaining debt, $52.4 billion worth, takes the form of medium-term notes and bonds.

We judge the immediate risks rather to be Sprint and, especially, Alibaba. "The market was predicting that Sprint's bankruptcy was imminent in early 2016," Santin observes, "when some of Sprint's senior unsecured bonds traded down to as low as 60 cents on the dollar and the company's five-year credit default swap traded up to 1,800 basis points (implying that Sprint had an 80% probability of default in the next five years) from 400 basis points in mid-2015. The wireless carrier's stock plummeted to under $3 from $5 a share, which implied a ¥650 (per share) impact on SoftBank's stock. SoftBank traded down to less than ¥5,000 from the near-¥7,000 level during most of 2015. The market might have been anticipating that Sprint could be written down to zero or that SoftBank could have been required to infuse it with cash.

"Since then," Santin proceeds, "Sprint has gotten some added support by mortgaging anything that wasn't nailed to the ground; it raised cash by issuing debt secured by wireless spectrum. Although Sprint's stock recovered quite well and traded as high as $9 a share earlier this year, it's quoted at less than $6 today.

"Alibaba could present a bigger problem. Suppose that BABA gave back half of the dollar gains it had on the past 12 months, or about $40 per share. Given that SoftBank owns about 768 million shares, a $40 ding would reduce SoftBank's market cap by more than $30 billion, or more than ¥3,000 per share."

Nikesh Arora was the second-in-command at SoftBank who quit in 2016 when it became evident that Son was in no hurry to make him first-in-command. In a post-resignation interview with *Fortune* magazine, Arora confessed that he didn't know how to value Didi, China's version of Uber, in which SoftBank had made an investment. Nor, he added, did he know "the right valuation for any of these companies"—i.e., early-stage tech businesses—in the SoftBank portfolio.

As for Son, the former No. 2 went on, he "has an idea per minute," works 12 to 16 hours a day and is slow to sell an investment (sometimes, as in the case of Yahoo!, much too slow). He is "an extremely positive person. Once he gets optimistic, I think sometimes he gets carried away."

"Every cycle has its poster child," says Brian Horey, president of Aurelian Management. You can't be sure who it will be until upside excess has turned into its downside mirror image. But for him, and for us, SoftBank is a leading contender for the cyclical laurels.

Mix the CEO's exuberance with cheap debt, high leverage and record asset values. Add the excitement of today's startling advances in robotics and artificial intelligence. Combine with the karmic report that the aforementioned "MBS," the Vision Fund's No. 1 limited partner, is also the rumored buyer of that $450 million road-show da Vinci. Totting them all up, what do you have? Perhaps a corporation destined to read about itself on page one of *The New York Times*—and not in a flattering way.

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