GRANT'S
INTEREST RATE OBSERVER®
Vol. 39, No. 16b 233 Broadway, New York, New York 10279 • www.grantspub.com SEPTEMBER 3, 2021

Son gets 'crazier'

Evan Lorenz writes:

In the first six months of the year, according to PitchBook, the average valuation of an early-stage venture company ballooned by 50%, to $93.1 million, while the average valuation of a later-stage tech company skyrocketed by 98%, to $914 million. For perspective, over the same six months, the Nasdaq 100 plodded to a gain of a mere 12.9%.

Now in progress is a return engagement with the longtime *Grant's* pick-not-to-click SoftBank Group Corp., (9984 on the Tokyo Stock Exchange and SFTBY on the American pink sheets). As bearish as we remain on the seventh largest Japanese company by market cap, we write not principally for the short-sellers (the two or three surviving ones can take care of themselves), but for any who wish to monitor the gaudy progress of history's greatest speculative boom—this one, our very own.

It's a truism that sky-high valuations are no enhancers of long-term investment returns, and sometimes not of short-term returns, either. Thus, the share prices of Full Truck Alliance Co. Ltd., Zymergen, Inc. and Zhangmen Education, Inc.—a trio of characteristically pricey SoftBank-sponsored tech IPOs—have plunged between 17% and 72% since the completion of their respective initial listings in the second quarter.

The torrents of venture-capital dollars have begun to worry even the people whose pockets that money was supposed to line. In the January–June period, again according to PitchBook, 8,000-plus v.c. deals attracted more than $150 billion, almost as much as the entire sector snagged in 2020. "We knew that [growing] into a crazy valuation would be really tough," Samir Kaji, who turned away venture dollars as a co-founder of Allocate, told the tech site The Information. "If the market changed, having a flat round or a down round can be a killer for a startup in the early days."

According to an Aug. 12 report from the same site, investors now routinely skip background checks for startup CEOs—there isn't time to finish them. Legal opinions on governance and capitalization, integral parts of careful investment underwriting in calmer days, now accompany only half of completed deals. So inundated are law firms with v.c.-related work that impatient bankers and their clients are deciding not to wait.

So maybe it's no surprise that the Securities and Exchange Commission charged Manish Lachwani, the former CEO and co-founder of Headspin, Inc., with cooking the books two Wednesdays ago. Lachwani, the SEC alleges, quadrupled the reported revenue of the software-as-a-service startup to secure a $1.1 billion valuation in a funding round in May 2020. Following this revelation, Headspin's backers marked down the value of the company to $300 million, which nonetheless placed the six-year-old startup ahead of the capitalization of 118 public companies in the Russell 2000. Headspin's actual cumulative revenue: $26.3 million.

Anyway, v.c. continues to rule the roost, as Yale affirmed last week when it appointed its head of venture investments, Matthew Mendelsohn, age 36, to succeed the late, great David Swensen as CIO of the university endowment. "In the past 10 years," the press release said, "the venture capital portfolio has returned 21.6% per annum, well in excess of the S&P 500 and relevant private equity benchmarks." Yale seems to be betting that past performance is, in fact, indicative of future results.

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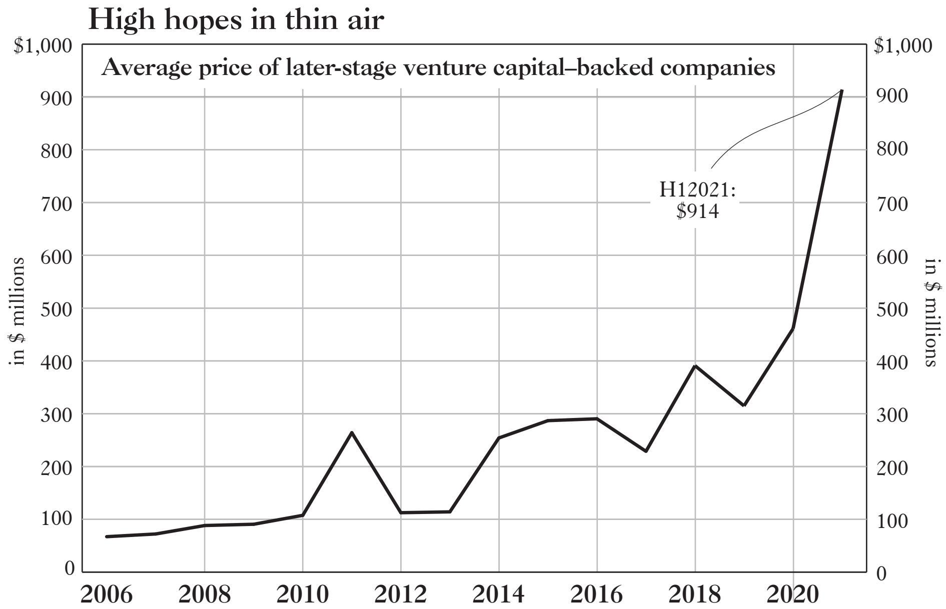
Which redirects us to SoftBank, writer of some of the biggest checks to early-stage companies and fountain of the idea that the twin concepts of risk and valuation are as obsolete as the telegraph.

On Aug. 10, Masayoshi Son, founder, chairman and CEO, told analysts that SoftBank has accounted for 10% of the investment in all unlisted artificial intelligence businesses worldwide since 2017. And what, exactly, is an AI investment? It used to be ride-sharing, said Son—Uber, DiDi, Grab, etc.—but now it's "consumers, transportation including ridesharing and logistics, frontier technology, proptech [as in 'property'], fintech, etc." So a big church, indeed, is artificial intelligence, you wonder what it isn't. In total, he noted, SoftBank has invested in about 300 AI companies over the past four years.

While SoftBank's business is easy to describe—it's an investment holding company—its financials are byzantine. Management consolidates the results of SoftBank Corp., the third largest telecom in Japan, though SoftBank owns just 40% of those outstanding shares. It reports profits stemming



source: PitchBook

from a 24.8% stake in Alibaba Group Holding Ltd., the Amazon.com, Inc. of China, in the line item called "income on equity method investments." Yet it records realized and unrealized gains and losses on its multitude of other investments in the profit-and-loss statement.

Net asset value—i.e., quoted market value less the debt to finance it—is divulged quarterly. Thus, as of June 30, SoftBank's NAV summed to $239 billion versus the current market cap of $96.8 billion. The aforementioned stake in Alibaba made up 39% of net assets, followed by SoftBank's investments in various company-run funds (34% of the total; Vision Fund 1, Vision Fund 2, the Latin America Fund) and other balance-sheet investments (27%; including stakes in T-Mobile U.S., Inc., SoftBank Corp. and PayPal Holdings, Inc.).

The front office leans on the NAV concept. Thus, as of June 30, SoftBank's standalone net debt, i.e., borrowings less cash at the holding company level, footed to ¥5.1 trillion, or 16.2% of net assets (this is what management calls its loan-to-value ratio). According to Son, SoftBank targets an LTV of 35% or less, so the balance sheet looks safe at a glance.

As long ago as the issue dated Dec. 15, 2017, *Grant's* called SoftBank the "epitome of the cycle"—and not in a good way. Nevertheless, we must admit that Masayoshi Son's creation has had a good pandemic. In the fiscal year ended March 31, it reported ¥4.99 trillion ($45.4 billion) in net income, the highest yearly profit of any public Japanese company ever. For reference, Facebook posted $29.1 billion in net income last year and Alphabet, Inc., the parent company of Google, reported $40.3 billion.

The price surge in speculative tech companies was a significant driver of those happy results. As of March 31, 2020, the $100 billion Vision Fund had registered a $0.8 billion loss. Fast-forward to June 30, 2021, and the mega fund posted a $58.2 billion gain. Vision Fund 2, which was launched in October 2019 and is yet to attract a single outside investor, looks after $25 billion, not including the $2.6 billion that Son recently pledged to invest.

Nor has SoftBank, which is all about fads, neglected that post-Covid obsession, the special purpose acquisition vehicle. It's sponsored its own SPACs (including SVF Investment Corp., SVF Investment Corp. 2 and SVF Investment Corp. 3), invested in SPACs via its SB Northstar business unit (this is the division that earned the moniker "Nasdaq whale" for its mega trades in U.S.-listed tech stocks and derivatives last year) and is using SPACs to take some of its less successful portfolio companies public (e.g., WeWork is slated to merge with BowX Acquisition Corp.).

"For the past 40 years," to quote from the S-1 registration statement of SVF Investment Corp., "SoftBank has invested ahead of major technology shifts. Now, we believe the AI revolution has arrived. We are on the verge of leaps in technology that could radically change the way we live, work, and play. Covid-19 has pulled this future forward by dramatically accelerating the adoption of digital services. We expect artificial intelligence to have an even greater impact than the PC, internet, and mobile stages of the information age."

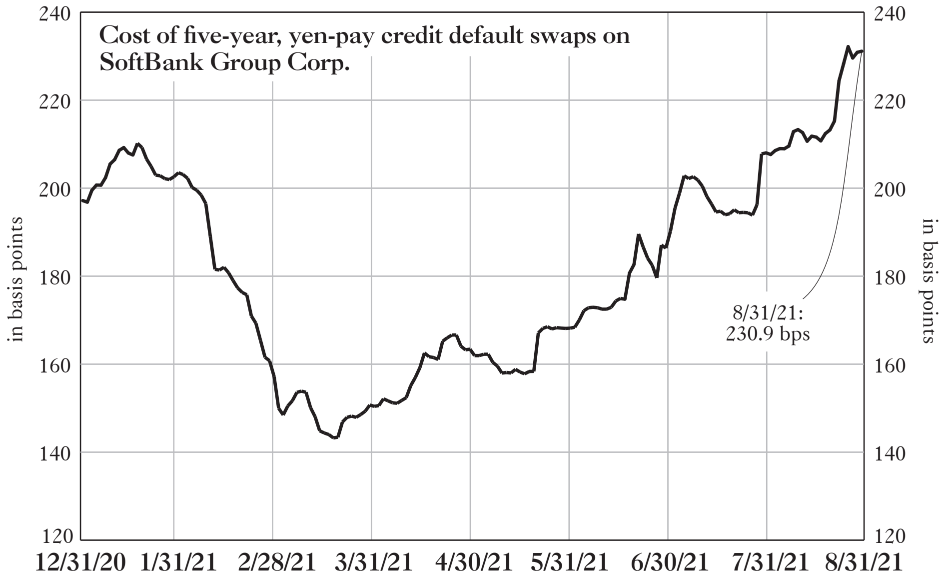
At the pandemic lows, SoftBank's share price had sold off to ¥2,687, down from ¥4,756 at year-end 2019. At that dark hour, management announced a ¥2 trillion share buyback program to be funded by asset sales. One year later, SoftBank had completed that program and retired 16.3% of the shares outstanding. Now the stock trades at ¥6,181.

Of course, EZ monetary policy has played its role in SoftBank's success. The conglomerate rated double-B-plus (penthouse-of-junk) issued 10-year, dollar-pay, senior unsecured bonds with a 5¼% coupon on June 30; the bonds have subsequently rallied to 100.7, a price to yield 5.16%. In its home country, SoftBank borrows for even less: The yen-pay subordinated 2¾% bonds of 2056 came to the market at par on June 3 and today fetch 100.95, a price to yield to worst of 2.53%.

It happens that each and every one of the 19 analysts who cover SoftBank rates the shares a buy. The reason, apart from that fetching-price action? "Because they [the SoftBank front office] have the great track record for success, they get the first phone call," Peter Milliken, who follows SoftBank for Deutsche Bank A.G., tells me. "The best companies gravitate towards them. Imagine if you were a fintech company trying to succeed in payments. You want to be able to draw from the expertise that they have developed from doing this in other markets."

As a holding company, SoftBank's only regular source of cash flow is the dividend it earns from its aforementioned stake in the SoftBank Japanese telecom. It's for this reason that, to fund its investments in Vision Fund 2, management borrows against the corporate stakes in Alibaba and T-Mobile. Of interest, too, is the fact that SoftBank does not choose to include the

Bond investors catch the scent



source: The Bloomberg

margin debt and pre-paid forward stock sale contracts in its loan-to-value calculation.

Of course, Son could settle his margin and pre-paid debt with the shares he's pledged to secure the loans, but the selloff in Alibaba makes him loath to do so, or so he said on the last earnings call (of which more later). As SoftBank has been settling these asset-backed borrowings in cash, they should be included in the net debt figure. Doing so would boost standalone net debt to ¥10.8 trillion from the self-reported ¥5.1 trillion and raise the LTV ratio to 35% from the company-calculated 16.2%, according to CreditSights. Importantly, this LTV ratio does not include the full impact of recently plunging Chinese tech stocks.

Son's personal contribution to the second Vision Fund involves a complex deal structure and still more margin debt. While the boss has pledged to contribute the aforementioned $2.6 billion, he is writing no check but depositing $500 million's worth of shares in SoftBank Group and providing his guarantee on borrowings needed to fund the rest.

This exposes both SoftBank and Son to downdrafts in the share prices of Alibaba, SoftBank and T-Mobile as well as to changes in value of early-stage tech concerns. The fact that the cost of a five-year credit default swap on SoftBank has risen to 230.9 basis points, from 143.2 basis points in March, suggests that debt investors have picked up on this connection.

"In a fight, who wins?" the SoftBank founder quizzed Adam Neumann, the founder of WeWork, according to *The Cult of We: WeWork, Adam Neumann, and the Great Startup Delusion* by Eliot Brown and Maureen Farrell. "The smart guy or the crazy guy?" Being crazy is how you win, Son answered his own question. "You're not crazy enough."

By leveraging the net worth of himself and SoftBank to early-stage companies, Son has an incentive to swing from for the fences—indeed, he *is* swinging for the fences. Nor, according to an Aug. 8 *Financial Times* report, are SoftBank's investment committees up to the task of taking the bat out of the boss's hands. "If Masa had already said yes," one unnamed employee told the paper, "who am I to object?"

The lackadaisical approach to risk has already led to problems with the now bankrupt Greensill Capital, the supply-chain financier and SoftBank investee that lent against fabricated invoices. Credit Suisse Group A.G., which managed funds that supplied the credit for Greensill-backed loans, is nursing losses and weighing its legal options against SoftBank, reports the *Financial Times*.

Son may be forgiven for not devoting his full attention to the Greensill/Credit Suisse shambles. SoftBank and he have bigger worries now: The Chinese Communist Party has made an example of Alibaba co-founder Jack Ma for daring to criticize the state, and the state, in return, has canceled the mega-IPO of Alibaba affiliate Ant Group Co. Ltd. and generally thrown a wet blanket over Chinese entrepreneurship.

Following the IPO of DiDi Global, Inc. on June 30, Chinese authorities ordered the removal of the ride-share company's app from online stores. The SoftBank-backed company's stock has dropped 41% since that Big Board listing and has led the SEC to freeze all Chinese IPOs. On Aug. 27, *The Wall Street Journal* reported that Chinese regulators are weighing a ban on U.S. IPOs for companies holding large amounts of consumer data, the very type of business in which SoftBank likes to invest.

American regulators had already begun to give mainland companies the side-eye. One point of contention is the local law that denies the U.S. Public Company Accounting Oversight Board access to Chinese audit work. Unless that policy is reversed by 2024, every Chinese company now trading in the United States, including Alibaba, could be subject to delisting, according to the letter of the December 2020 Holding Foreign Companies Accountable Act.

A more immediate threat to what the Federal Reserve likes to call the "smooth functioning" of markets is President Xi Jinping's new hobby horse of "common prosperity." While income redistribution is on-brand for the general secretary of the Chinese Communist Party, it is not exactly music to the ears of foreign investors. Playing to the new politics, online retailer Pinduoduo, Inc. announced that it would donate Rmb 10 billion ($1.5 billion) in future profits to charities as it reported earnings on Aug. 24.

Since Feb. 16, the Nasdaq Golden Dragon China Index, which tracks mainland companies listed in the United States, has dropped by 44.7%. Over the same span, the share price of Alibaba, the single largest component to SoftBank's net asset value, has slumped by 38.3% (and has almost been sawed in half since last October).

Meanwhile, China's slow-moving credit crisis grinds on, Logan Wright notes in an Aug. 19 analysis for the Rhodium Group. "The credit stress that is rising onshore among local governments has been generally overlooked so far amidst the higher-profile Huarong and Evergrande cases, but pressure on localities has reached a key inflection point after over a decade of rapid investment growth and debt expansion," Wright reports. "Local governments, starved of financial resources sufficient to repay their debts, now must make difficult choices concerning which state-owned firms they can afford to support."

How this bears on SoftBank is clear enough. As noted, Alibaba constituted 39% of the June 30 NAV. And as Son observes, 23% of the investments in the Vision funds and the Latin American funds (which together accounted for 34% of midyear net assets) are domiciled in China. In total, then, 46.8% of NAV is derived from China-related investments.

At June 30, SoftBank shares changed hands at 40.5% of NAV. At first glance, the discount might seem extreme, but the harder one looks, the more reasonable it appears.

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